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REPORT BY THE

Comptroller General

OF THE UNITED STATES



LM120475

Assessment of Admiral Rickover's Recommendations To Improve Defense Procurement



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The Honorable William V. Roth, Jr.
Chairman, Committee on Governmental
Affairs
United States Senate

The Honorable Joseph P. Addabbo
Chairman, Subcommittee on Defense
Committee on Appropriations
House of Representatives

This report summarizes our assessment of Admiral Rickover's recommendations for improving Department of Defense procurement. We have also suggested actions for implementing some of these recommendations and alternatives to those recommendations we cannot fully endorse. We performed this review in response to your requests.

As arranged with your Offices, we are sending copies of the report to Government agencies and officials, congressional committees, contractors, and individuals who have responsibility for the matters discussed. Copies will also be available to other interested parties upon request.

for Milton J. Aoulan
Comptroller General
of the United States

D I G E S T

GAO assessed Admiral Rickover's recommendations to improve Department of Defense (DOD) procurement. The assessment was made at the requests of the Chairmen, Senate Committee on Governmental Affairs and Subcommittee on Defense, House Committee on Appropriations.

Admiral Rickover's recommendations fall into three areas:

- The utilization of resources.
- The conduct of procurement itself.
- The resolution of contractual conflicts.

UTILIZATION OF RESOURCES

Admiral Rickover's recommendations for resource utilization cover three topics--avoiding hasty labor buildups in shipyards, restarting nuclear ship construction in a Navy-owned yard and withdrawing financial support for industry-initiated research and development.

Avoiding hasty workforce buildups

Admiral Rickover believes hasty labor buildups in private shipyards were a root cause of the large shipbuilding claims of the 1970s. He believes they cause delivery delays, cost overruns, and industry interest to shift from building ships to developing claims against the Navy. He urges the Congress and DOD to be alert to such buildup signs emerging in the current expanded shipbuilding program.

DOD agrees and plans to contract with only those firms which have sufficient skilled labor. GAO questions this approach, however, because the contracting process has not been a remedy in the past. Further, this approach is unreliable due to (1) disagreement on shipbuilding capacity and (2) frequent lack of alternative sources.

The Committee should require DOD to include, as part of its annual report to the Congress, an assessment of (1) the extent of future buildup problems and (2) the actions needed to moderate them, including these options:

- Relieving nuclear submarine overhaul demands on private yards by expanding the Navy's own capacity.
- Not using nuclear capacity for conventional work.
- Reserving nuclear industrial base capacity for future needs by compensating a private yard, when necessary. (See pp. 6 to 11.)

Restarting in-house nuclear submarine construction

Admiral Rickover points out that despite the large claims and other problems experienced during the last decade the Navy has no alternative but to keep awarding contracts to the same two private yards. He favors restarting nuclear submarine construction in a Navy-owned yard.

DOD says there is no clear requirement at present to restart in-house construction but wants to maintain the option. GAO believes the need for a third yard depends on whether a congressionally funded buildup occurs and how extensive it is.

The Committee should (1) monitor the effects of the current buildup through the annual DOD industrial base assessments suggested above and (2) periodically consider the need for a third nuclear construction shipyard. (See pp. 12 to 15.)

Withdrawing support for industry-initiated research and development

Admiral Rickover favors abolishing or drastically cutting back Government support of industry-initiated research and development because (1) he considers it a subsidy, (2) DOD's monitoring of it is superficial, and (3) the Government has no control over or rights to the work it pays for.

DOD disagrees, as does GAO, on the advisability of ending financial support for this activity. GAO findings reaffirmed earlier congressional evaluations of industry-initiated research and development activity:

- It is an essential activity of any firm bidding on high technology projects.

--Without this activity the Government would not be taking full advantage of the private sector's innovative capabilities.

--Like any customer the Government should pay its due share of a regular business cost.

The Navy has recently redesigned its program to correct some of the past weaknesses pointed out by Admiral Rickover in monitoring these contractor activities.

The Committee should require DOD to (1) closely monitor the revised Navy program, (2) have an independent panel of experts at a later date assess DOD's overall effectiveness in monitoring industry-initiated research and development, and (3) negotiate provisions giving the Government free use of the resulting inventions. (See pp. 16 to 23.)

CONDUCT OF PROCUREMENT

Admiral Rickover made several recommendations to improve the conduct of procurement. The principal theme is that the Government should use more leverage and business judgment and be a more demanding customer in its dealings with contractors.

Requiring DOD certification on terms and conditions

Admiral Rickover is concerned that once DOD requests funds for a ship and the Congress approves, the Government loses its leverage over sole-source shipbuilders. He believes this leaves the Navy in a poor bargaining position in negotiating suitable terms and conditions.

He wants the Navy to use its decisions on what will be included in the budget as leverage to help resolve contractual differences with sole-source contractors. He would require DOD to certify to the Congress in budget requests that these contractors have agreed to suitable terms and conditions.

DOD says that this recommendation is impractical. GAO believes that "certification" is too cumbersome but that linking sole-source business issues with budget decisions has merit. The Committee should encourage this practice. (See pp. 24 to 28.)

Not relying heavily on
special financial incentives

Admiral Rickover criticizes the Government for relying on special financial incentives instead of good management to get contractors to perform efficiently. He says these contractual provisions do not work; instead they create grounds for claims and the Government ends up paying more without actually getting improved contractor performance.

DOD states that incentives do work, but negotiation of the right targets is critical and contract changes can negate their effectiveness.

GAO believes that extreme care and case-by-case decisions are needed when using these special financial incentives, especially in shipbuilding.

The Committee should require DOD to develop a policy limiting use of these special incentives. (See pp. 28 to 33.)

Awarding contracts to other
than the low offeror

Admiral Rickover believes that the competitive system is subverted by deliberate underbidding by contractors who are then able to pass on their losses to the Government. He is concerned that a more efficient contractor can be shut out resulting in both higher costs and late deliveries to the Government. He believes that statutory authority is needed to refuse unrealistically low offers that would likely injure the Government.

DOD believes source selection evaluation factors can handle these problems. GAO believes, however, that because unrealistically low offers harmful to the Government cannot always be avoided and are surrounded by controversy, additional regulatory or legislative authority is needed to protect the Government's interest in certain cases.

The Committee should either propose legislation or ask DOD to modify its Defense Acquisition Regulation authorizing the agency head to reject low offers under certain conditions. That is, when in the agency head's judgment (1) the Government lacks sufficient assurance that it can

prevent a contractor suspected of underbidding from recovering at Government expense through contract changes or follow-on contracts and (2) acceptance of another offer is more likely to result in lower cost to the Government. (See pp. 33 to 42.)

Not tolerating poorly performing contractors

The Admiral would like the Government to use its contract award decisions as leverage to force contractors to correct serious performance problems.

GAO agrees that contractor performance should be emphasized in awarding new contract work.

The Committee should require DOD to report on the results of a DOD-initiated action to increase use of prior performance in awarding contracts. This information should be helpful to the Committee in determining whether additional actions are needed. (See pp. 42 to 46.)

RESOLUTION OF CONTRACTUAL CONFLICTS

Finally, Admiral Rickover made several recommendations to help resolve contractual conflicts between DOD and its contractors.

Limiting the period for submitting claims to one year

Admiral Rickover asserts that the lack of a time limit on claims submission allows contractors to wait several years to determine contract profitability and then to claim enough to cover contract overruns. He recommends a 1-year time limit for submission of fully documented claims.

Some experts say a 1-year limitation would unduly burden contractors and encourage them to file claims just to protect themselves from all eventualities. DOD agrees that a time limit is necessary but is unsure how long it should be.

GAO believes a time limit is needed. The Committee should obtain additional views on the appropriate time period and propose legislation requiring timely claims submissions. (See pp. 47 to 53.)

Deterring work stoppage by stopping payments corporate-wide

The Admiral is concerned that shipbuilders are able to modify their contracts or get special financing by work stoppage threats. He recommends that Congress require DOD to stop payments on all contracts with a corporation if any segment of that corporation stops work on any DOD contract.

DOD disagrees and says such a policy of stopping payment is neither legally sound nor practical. GAO concurs with DOD's objections but believes DOD's present policy of terminating the contract and procuring the items from another source when work stoppages occur is also unworkable on large ship construction contracts.

The Committee should require DOD to develop a policy for such cases and submit legislation if necessary. (See pp. 53 to 58.)

Enforcing fraudulent claims statutes

During the 1970s Admiral Rickover and other Navy personnel thought some shipbuilders' claims were so exaggerated that the claims were sent to the Justice Department to be investigated as possibly fraudulent.

Admiral Rickover believes the Justice Department has been ineffective with these cases because it has been looking for a forged or altered document rather than a web of sophisticated fraud. He recommends that the Justice Department vigorously enforce criminal laws against false claims.

DOD agrees, but notes that prosecution in these cases is difficult. Justice has now established a special unit to handle future fraud cases.

GAO believes DOD should be required to establish, in consultation with Justice, claims handling procedures and standards that discourage false claims, make evaluation easier, and facilitate prosecution where fraud is suspected. (See pp. 58 to 64.)

EXTERNAL COMMENTS

This report incorporates comments received from Admiral Rickover, DOD, Justice and two major shipbuilders. Commentors disagreed with some of the GAO suggestions for congressional consideration

and Admiral Rickover thought they should be strengthened. These differences are discussed in appropriate sections of the report. (See pp. 65 and 66.)

C o n t e n t s

		<u>Page</u>
DIGEST		i
CHAPTER		
1	INTRODUCTION	1
	History of Admiral Rickover's recommendations	1
	The Navy shipbuilding environment	2
	Objectives, scope, and methodology	4
2	UTILIZATION OF RESOURCES	6
	Avoiding hasty labor buildups	6
	Restarting Naval nuclear submarine construction	12
	Withdrawing DOD support for industry- initiated R&D	16
3	CONDUCT OF PROCUREMENT	24
	Requiring DOD budget certification on terms and conditions	24
	Not relying heavily on special financial incentives and bonuses	28
	Awarding contracts to other than the low offeror	33
	Not tolerating poor contractor performance	42
4	RESOLUTION OF CONTRACTUAL CONFLICTS	47
	Limiting the period for submitting claims to one year	47
	Deterring work stoppages	53
	Enforcing fraudulent claims statutes	58
5	OVERVIEW - EXTERNAL COMMENTS AND OUR EVALUATION	65
	Admiral Rickover	65
	Defense Department	65
	Justice Department	65
	Industry	65
APPENDIX		
I	Letter dated March 12, 1982, from the Chairman, Defense Subcommittee, House Committee on Appropriations	67
II	Letter dated June 18, 1982, from the Chairman, Senate Committee on Governmental Affairs	68
III	SSN-688 class submarines acquisition history	69

APPENDIX

		<u>Page</u>
IV	Letter dated December 11, 1982, from Admiral Hyman G. Rickover	73
V	Letter dated January 11, 1983, from the Assistant Attorney General for Administration, Department of Justice	79
VI	Letter dated January 4, 1983, from Edward J. Campbell, President and Chief Executive Officer, Newport News Shipbuilding	82
VII	Letter dated January 13, 1983, from Principal Deputy Under Secretary of Defense for Research and Engineering	89

ABBREVIATIONS

DOD	Department of Defense
GAO	General Accounting Office
IDA	Institute for Defense Analysis
R&D	Research and Development

CHAPTER 1

INTRODUCTION

The Chairman of the Defense Subcommittee, House Committee on Appropriations, asked us to review recommendations to improve Department of Defense (DOD) operations which were made by the distinguished Admiral Hyman G. Rickover, USN, retired. Admiral Rickover, the former Director of the Naval Nuclear Propulsion Program, offered the recommendations during congressional testimony on January 28, 1982, upon his retirement. The Chairman asked us to review the recommendations and determine:

--If they are both feasible and practical.

--The time span in which they could be implemented with the least disruption.

--Some insight as to their potential savings.

The Chairman asked that our report be submitted prior to budget hearings with DOD. These hearings are expected in February 1983. (See app. I.)

The Chairman of the Senate Committee on Governmental Affairs also requested an analysis of Admiral Rickover's recommendations. The Senate Committee agreed to the same scope and timing as the House request. (See app. II.)

HISTORY OF ADMIRAL RICKOVER'S RECOMMENDATIONS

In the 1950s Admiral Rickover pioneered the development of the nuclear-powered submarine and, in both his Navy and Atomic Energy Commission roles, directed the construction of the first civilian nuclear power plant. Subsequent versions of the nuclear submarine have become the mainstay of the Navy's tactical submarine fleet and one of three parts of DOD strategic forces. Other major combatant ships which are now nuclear powered include aircraft carriers and cruisers.

For some two decades the Congress has asked Admiral Rickover to appear periodically before various committees to present his views on a wide range of DOD matters. Some of these congressional appearances addressed the large claims made against the Government by several Navy shipbuilders during the 1970s. At these hearings, Admiral Rickover offered some of the recommendations which are now the subject of this report. The Admiral offered others for the first time during his farewell testimony.

The Admiral's farewell testimony addressed DOD procurement issues, organization and management, and basic military personnel

policies. (See app. III.) This report deals only with the Admiral's procurement-related recommendations. The remaining issues will be covered in subsequent reports and briefings.

THE NAVY SHIPBUILDING ENVIRONMENT

During the last three decades, while new ships were becoming more technologically complex, the Navy shipbuilding environment has seen several major policy shifts.

- 1950s: The Navy allocated the larger ships to selected shipbuilders to maintain a broad mobilization base.
- Mid-1960s: The Navy shifted to total package procurement for two new ship classes. These procurements combined design and major production efforts into one large contract awarded using competitive negotiations.
- Late 1960s: The Navy switched to incentive-type contracts also using competitive negotiations.
- Late 1970s The Navy switched to cost-type contracts for
to present: lead and early follow ships. Afterwards,
fixed-price contracts are used with incentive
arrangements.

During the 1970s claims against the Navy from the three largest shipbuilders gradually built up to \$2.7 billion. After serious disagreement for several years the claims were settled for \$1.5 billion. ^{1/} A large part of the settlement was made under the equitable and special management powers of Public Law 85-804. These powers permit price increases without legal consideration where the contractor's productive ability will be impaired by a financial loss and its continued operation is essential to the national defense.

Despite the major claims controversies of the recent past, the Navy and its shipbuilders are in a sense "locked in" and must continue to depend on each other. This is because in the commercial field U.S. shipbuilders are not competitive with foreign builders. Thus, their primary customer is the Navy. Similarly, the Navy is limited in its sources of major combatant ships to a few U.S. shipbuilders. Sources are even more limited in the cases of nuclear-powered ships--the focus of many Rickover procurement-related recommendations. Only two private shipbuilders--Electric Boat and Newport News--are "nuclear qualified" for new construction.

^{1/}A small part of this settlement is estimated by the Navy and will not be incurred until all the involved contracts are completed.

There are other barriers to entry of new companies into the shipbuilding industry. These include huge initial investments, difficulty in finding skilled labor, unstable demand, and Government control. Figure 1-1 highlights characteristics of the current Navy shipbuilding environment.

FIGURE 1-1

Some Characteristics of the Navy Shipbuilding Environment

Lead ship design	Done by the shipbuilder under separate design contracts but closely controlled by the Navy for nuclear safety and other reasons.
Construction process	Lengthy; complicated by weapon system integration problems, crew life support facilities, nuclear technology, frequent contract changes and no mass production.
Competition	<u>Commercial</u> - U.S. shipbuilders are not competitive with foreign yards. <u>Defense</u> - U.S. shipbuilding is a defense-protected industry. Little competition in research and development, some in production. Usually only one or two builders for each ship class.
Demand for ships	Uncertain and unpredictable due to changing perceptions of defense needs.
Growth	Unstable, high labor turnover (two or three times that of comparable industries).
Ownership	Most larger shipbuilders are owned by, and have the financial influence of, conglomerates.
Acquisition policy	Has undergone major changes in the last three decades. Current emphasis is, when prudent, to try to maintain dual sources of supply (one being the lead ship designer). Cost-type contracts used on initial ships until design is more mature; then, fixed-price incentive contracts employed with incentive sharing arrangements up to 50 percent.

OBJECTIVES, SCOPE, AND METHODOLOGY

This review was performed in accordance with generally accepted government auditing standards. It was conducted during the period June through November 1982. Our primary objective was to assess the need for further action on Admiral Rickover's recommendations. We researched the recommendations in various congressional hearings and published papers including six volumes of Admiral Rickover's papers which were published by the Joint Economic Committee in mid-1982.

A number of studies and other papers have been published on some of the recommendations made by Admiral Rickover as well as on the Navy shipbuilding claims problems in general. We examined these as well as the relevant prior work by our Office. We also analyzed selected contractual documents on past and current shipbuilding programs.

We consulted with Admiral Rickover, his former staff, as well as officials and program managers at various levels in the Navy and DOD, including:

- Those dealing with contracting, claims, acquisition policy, and shipbuilding programs in the Naval Sea Systems Command.
- The heads of the naval systems commands.
- The headquarters officials, Naval Material Command.
- The Office of the Secretary of the Navy.
- The Office of the Under Secretary of Defense, Research and Engineering.

We also consulted with some outside experts, including representatives of industry and academia as well as claims lawyers and retired Navy officials. In addition, early in the review we obtained a DOD/Navy position on each recommendation.

Admiral Rickover's procurement-related recommendations are long-term policy and industrial-base issues that are not readily susceptible to realistic cost saving estimates. Timing of implementation is generally not an issue. The recommendations, in large part, are designed to avoid recurrence of the large shipbuilding claims of the 1970s, which caused great disruptions, administrative costs, and delays in achieving critically important defense capabilities.

Admiral Rickover's procurement related recommendations fall into three categories:

- The utilization of resources.
- The conduct of procurement.
- The resolution of contractual conflicts.

Succeeding chapters of this report will address each of these areas. They review Admiral Rickover's various concerns leading to the recommendations and summarize results of our findings and analysis. In addition, they contain actions for the Committees to consider and take up with the Secretary of Defense. Such actions are intended to serve as a basis for further deliberation and followup on the issues Admiral Rickover raised.

There was a consensus on the reality of the problems addressed by Admiral Rickover's recommendations. We did not, however, independently confirm his assertions in the various background discussions of the issues.

CHAPTER 2

RESOURCE UTILIZATION RECOMMENDATIONS

Admiral Rickover's recommendations relating to resource utilization cover three topics. First, he wanted the Navy to avoid the recurrence of hasty labor buildups in private shipyards which he believes was a root cause of the huge claims in the 1970s. Secondly, the Admiral wanted the Government to reestablish a naval shipyard for construction of nuclear-powered submarines to provide needed industrial capacity and be an alternative to private yards where the latter dealt improperly with the Government. Finally, for various reasons he favored withdrawing DOD financial support from research and development that is initiated and controlled by industry.

AVOIDING HASTY LABOR BUILDUPS

Building sophisticated nuclear-powered naval ships with their weapon systems and many contract changes is a lengthy and complex undertaking. The ability to build more ships is limited not only by few nuclear-qualified shipyards but also by the availability of skilled labor. Because the industry is labor intensive, wide swings in shipbuilding demand create drastic personnel changes and other inefficiencies.

Steep labor buildups plagued nuclear shipbuilding programs during the 1970s. Labor at one company, for example, rose from 12,000 in 1971 to 18,000 in 1975, and it more than doubled to 26,000 in 1977. Unable to recruit locally, the company offered bonuses and chartered up to 50 buses a day to bring employees from many miles away. According to Navy officials, the number of skilled workers dropped from 85 to 50 percent and productivity declined accordingly.

Admiral Rickover complained that:

- These too rapid buildups in private shipyards caused extensive schedule delays and cost increases.
- Once these buildup problems began to manifest themselves in financial losses, contractor interest shifted from building ships to developing large claims against the Government to cover contract overruns.
- The shipbuilders' inability to effectively manage the labor buildups needed to fulfill their contracts ultimately resulted in a \$2.7 billion backlog of unsettled claims against the Navy. 1/

1/Electric Boat officials told us that official Navy pronouncements recognize that the claims were caused also by premature authorization of ships and premature use of fixed-price type contracts during design phases of a new ship class.

Admiral Rickover's recommended solution

In view of the current administration's expanded shipbuilding program, Admiral Rickover urged that the Congress and DOD take care not to repeat the rapid labor buildup problems experienced during the 1970s.

DOD's position

DOD concurred with the Admiral's recommendation. Contract award procedures are in place, DOD said, to evaluate the capability of potential contractors to fulfill the cost and schedule requirements of their proposed contracts. DOD intends to contract only with those who during the source selection process have demonstrated that they have, or have ready access to, the labor needed to meet the contractual requirements. DOD added that after contract award, the Government monitors contractors' performance on-site to identify problems and seek corrective action.

Findings

Many people inside and outside DOD agree that rapid labor buildups and declines have been an underlying cause of shipbuilding inefficiencies, defects in product quality, schedule delays, and ultimately, large claims against the Government. The Secretary of the Navy expressed the problem this way:

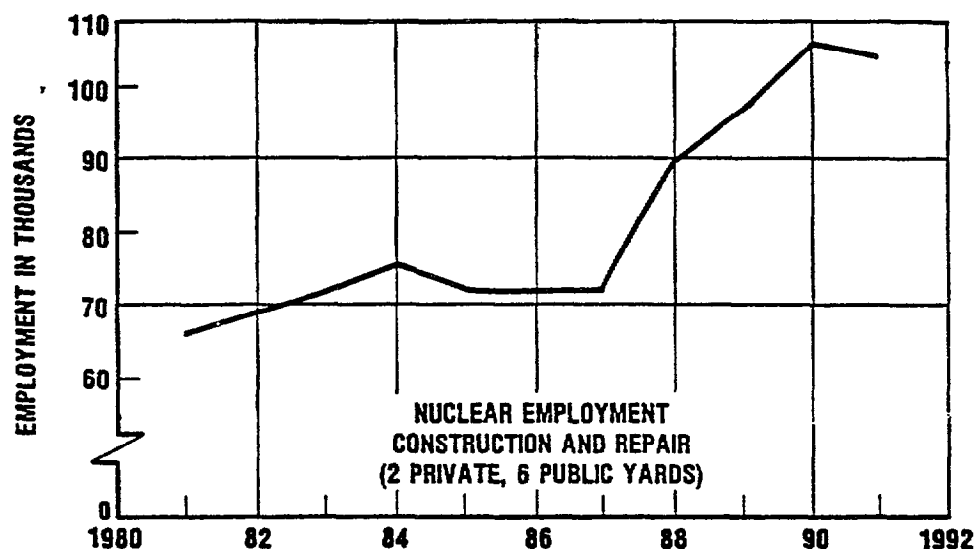
***when you have this up and down which is unfortunately the recent history of our shipbuilding program, you get these radical surges in manning requirements in the yards that are terribly disruptive, wasteful, and inefficient.

Historically, Government shipbuilding programs have experienced steep peaks and valleys and commercial work has not been available to smooth out the workload. During the downswings, many people with unique skills in shipbuilding are laid off. During the upswings, unskilled people are recruited too fast to be properly trained. An example cited by a Navy program manager was that journeyman welders became supervisors overnight and people with no experience became welders.

Currently, the industry is in a valley because relatively few ships have been authorized in recent years. Employment levels have dropped off except for nuclear certified yards. Navy studies show that future buildups are expected to be more of a problem in nuclear than conventional ships. For example, a major buildup will occur in this area during the mid-1980s because of (1) the increasing number of nuclear submarines requiring major overhaul/refueling and (2) the increased rate of nuclear attack submarine construction from two to four per year. This buildup is expected to peak in the 1987-90 timeframe during which time employment should increase by 35,000. (See fig. 2-1.)

FIGURE 2-1

NUCLEAR SHIPBUILDING INDUSTRY LOADING^{1/}



Source: Institute for Defense Analysis Study, January 1982.

Experts said the ideal answer to overly hasty buildups is for the executive branch and the Congress to agree on and commit this country to a long-term shipbuilding plan. However, a stabilized plan of this nature would have to span several Congresses and the practicality of committing future Congresses was questioned.

Changes in the political environment and in defense projections from one administration to the next tend to make the roller coaster effect inevitable. Some say that to even out the workload the Navy should allocate at least some ships to contractors rather than let the lowest competitive price dictate where they are all built. This would alleviate situations, for example, where one of only two possible sources is so overloaded that price competition would not be effective anyway.

Others noted that the procurement strategy must be tailored not only to the inherent instability of the Navy program but also to the very narrow industrial base for nuclear construction and overhauls. Such a strategy would call for (1) generally splitting submarine quantities between the two private shipyards and (2) varying the quantities awarded to each company based on their performance, price, and available capacity. This strategy, which the

^{1/}Public yards only do nuclear overhaul and repair. Loading includes nuclear cruisers which since have been dropped from fiscal 1984 budget planning. (See next section on restarting a naval shipyard.)

Navy is already using, combines some aspects of price competition and ship allocation. The strategy should help during the current buildup until the peak period arrives when workload begins to exceed the capacity of both private nuclear yards.

The Navy's approach to handling a buildup, such as the one expected in the late 1980s, is to ask contractors to furnish workload data with their contract proposal. This is not new. The contractor data is compared with overall industry data which the Navy collects through its own sources and the Shipbuilder's Council. Navy officials admit, however, that they do not have good information on a particular contractor's locally available workforce, skills, and hiring ability. The Navy is attempting to obtain at least some information on the available labor pool through the Department of Labor.

Complicating the control of overly rapid buildups is the willingness of companies to take contracts requiring rapid buildups. We also learned that the Navy and industry perpetually disagree about industry capacity. Therefore, a Navy decision to throw out the low bidder on those grounds may be contested by the company and taken into court.

One Navy official acknowledged that if the overload situation does develop in the late 1980s and trained labor is not available to build congressionally approved ships, it is extremely doubtful that the Navy would seek to avoid buildup problems by returning the money unspent to the Congress.

Electric Boat officials said that in their view rapid buildups are inherent in defense shipbuilding and that both Government and industry must accept them as a "fact of life." They said periodic fluctuations in defense requirements cost a lot of time and money and that industry and Government must learn how best to cope with them and accept the additional costs involved.

Our analysis

There is general agreement on the adverse effects of rapid buildups in the shipbuilding industry. The issue is how best to cope with and moderate their effects.

The implication in DOD's position on Admiral Rickover's recommendation is that those contractors lacking sufficient labor skills would be eliminated from contract award regardless of their price offer. We have not been able to identify cases where the Navy has

used the source selection process to do this in nuclear construction, despite massive buildups in the past. 1/

There is further doubt about the Navy's ability to effectively use the source selection process to control buildups since there is only one builder for aircraft carriers (Newport News) and one builder for the strategic Trident submarine (Electric Boat). Since these two yards are also the only ones that can build nuclear attack submarines, if one is full of other work, or doing high priority fleet overhaul, the remaining one is a de facto sole-source for attack submarines. This means the Navy could be dealing, in effect, with a single source for all nuclear ships.

Normally, each contract is awarded independently with no explicit consideration given to anticipated future workload for which a particular company is the program's only source. The Navy contends that future capacity needs cannot be used as a disqualifying factor until the Congress actually authorizes and appropriates the funds. Until that occurs, a future program may or may not materialize and shipbuilders know they must try to obtain any contract on which there is present competition rather than depend on the possibility of future work.

The ideal solution to this problem would be an executive and legislative branch agreement on a shipbuilding plan that could be adhered to on a long-term basis. Such an agreement would permit suitable adjustments to the industrial base and better planning of competition between shipbuilders.

In the absence of a long-term agreement, the Navy may need authority to preserve the narrow nuclear industrial base. For example, the Navy could reserve future contractor capacity or preclude its use on conventional work when making individual contract awards. Aside from obvious national security considerations, one rationale for these measures is the huge investment the Government has made in these two private yards to certify them for nuclear construction. In light of this investment, the Government should be able to expect the yards to dedicate themselves to the program. Because these yards are profit conscious business ventures, the Government should consider compensating them for setting aside a portion of their production capacity for future work which cannot be guaranteed.

1/ Apart from the source selection process, the Navy did direct an award to Newport News because of Electric Boat's heavy backlog, but this was a necessary adjustment because of earlier buildup problems, not a preventive measure for future ones.

Matters for congressional consideration

The Committee should require DOD, as part of its annual report, to include an assessment of (1) the extent of future buildup problems and (2) the actions needed to best utilize existing nuclear industrial base capacity, including these options:

- Relieving the demand on private yards for nuclear submarine overhauls by expanding the Navy's own overhaul capacity.
- Preserving the limited nuclear industrial base by not using it on conventional work.
- Reserving nuclear overhaul/shipbuilding capacity for future needs by compensating a private yard for setting aside capacity, when necessary.

Industry comments and our evaluation

Newport News takes exception to limiting conventional work at private nuclear yards and to reserving future capacity. Newport News says the investment required for nuclear work is higher than for conventional work yet the profit margins permitted are lower. Therefore, until the profit margins improve on nuclear work, Newport News intends to bid on conventional work and would consider it illegal for the Government to forbid it. Newport News also considers it illegal for the Government to attempt to reserve future nuclear capacity by excluding the use of such capacity from current contract awards. Finally, Newport News claims there is plenty of nuclear overhaul capacity in private and public yards for many years to come.

Newport News does not appear to recognize in its comments that we are proposing a series of options to be exercised only if necessary to avoid the type of chaotic buildup problems experienced in the 1970s or a several hundred million dollar investment in a new nuclear yard (see next section). Therefore, these are options for emergency conditions which may or may not occur. Should an emergency occur and the Congress, in consultation with DOD, decide to exercise these options, legislation could then be enacted to resolve any legal problems associated with them.

With respect to the Newport News claim of excess nuclear overhaul capacity, both the Institute for Defense Analysis and DOD have concluded that there will be a shortage beginning in the mid or late 1980s when all requirements (new construction and overhaul) are considered.

RESTARTING NAVAL NUCLEAR SUBMARINE CONSTRUCTION

In the 1960s, Admiral Rickover observes, there were two Navy-owned and five private yards building nuclear-powered attack submarines. Today there are two yards, both private. In recent years he says the combined output of attack submarines from these two yards has averaged two per year. Admiral Rickover contends that this delivery rate will not sustain current force levels or permit replacing obsolete or wornout submarines.

He stated that a provision in the 1934 Vinson-Trammell Act requires the Navy to build about half of its ships in Navy shipyards unless the President waives this requirement in the public interest. Since 1967, national policy has been to construct all Navy ships in private shipyards. Presidential approval of such action has been routinely requested and approved.

Admiral Rickover was concerned about recurrences of schedule slippages and large financial claims of the 1970s. He stated that

- the claims tied up the Navy contractually for many years and diverted its valuable technical resources from normal tasks and

- without another source the Navy had no alternative but to award more contracts to the same two private yards.

Admiral Rickover has concluded that constructing some submarines in a Navy-owned shipyard would provide needed competition to prevent private shipyards from dictating the terms and conditions under which ships are built. He said this would also provide (1) a yardstick for comparing the reasonableness of private shipyard costs, and (2) a stronger in-house capability to handle emergency repairs and oversee private shipyard programs.

Admiral Rickover's recommended solution

Admiral Rickover recommended that the Congress require the Navy to reinstitute nuclear submarine construction in a Navy-owned yard to provide needed construction capacity and alternatives to contracting with private yards when those yards deal improperly with the Government.

DOD's position

DOD stated that alternative shipbuilding sources, especially within the Government, provide a major business advantage to the Navy under certain circumstances, such as adverse business relationships with one or more submarine shipbuilders. However, DOD added that a clear requirement for a third nuclear construction shipyard based on cost or capacity has not been identified.

DOD also referred to the January 1982 Institute for Defense Analysis (IDA) study which concluded that there is sufficient capacity in the two yards to meet DOD's 5-year plan for constructing nuclear ships. The study recommended a review of how naval shipyards can be organized and equipped for quick conversion to efficient ship construction in the event a future need is identified. DOD stated that based on this review

- selected shipyards should be provided additional production equipment and plant facilities to enable them to quickly convert to new construction work and

- priority should be given to those upgrades that would enhance nuclear overhaul and repair work.

Findings

In the 1950s and 1960s, construction of submarines in some of the Navy yards took longer to complete than private yards with costs running about 30 percent higher. Although phased out of construction in the 1960s, Navy yards still do most of the nuclear overhaul work. Advantages and disadvantages to restarting naval shipyard nuclear construction are highlighted in figure 2-2.

FIGURE 2-2

Reopening a Navy Yard for Nuclear Construction

Advantages

- Broaden the industrial base, level out workload and build surge capacity.
- Strengthen in-house technical capability and provide a valuable training ground for Navy people to monitor private yards.
- Provide business leverage in resolving private yard issues.
- Provide limited competition and yardstick for comparing reasonableness of private yard costs.

Disadvantages

- Need to expand the Government's work force, acquire modern facilities, and invest several hundred million dollars. Government manpower ceiling would have to be raised.
- Operating cost may be from 19 to 35 percent higher than in private yards, even with equivalent productivity, because available locations are limited to the west coast which has much higher pay scales than the two east coast private yards.
- Running a new construction yard could stretch the Navy's already thin technical and business management capability. The Navy's

capability today is instead directed toward acquiring ships from private industry, not managing their construction.

--Periodic pressure could be exerted to keep the new public or private yards filled with work. If there is not work to go around, this could mean eventual loss of one of the two private yards or reduced efficiency in the Navy yard.

Source: Interviews with Navy officials and IDA study.--"The Reinstitution of the Construction of U.S. Navy Combatant Ships in U.S. Government Owned Shipyards" by John N. Fry and John D. Wells, January 1982.

Experts informed us that if there were a firm commitment to a long-term program (of 10-15 years) for nuclear-powered ships, Admiral Rickover's recommendation would be much easier to address because the needed yard capacity could be determined. Navy ship programs, however, have been anything but stable. (Navy analysts referred to them as "yo-yo" and "feast or famine situations.") In addition, according to Navy officials, there is a constant disagreement between the Navy and the two private contractors about how much work industry can absorb.

Navy officials believe that only an existing Government yard now doing nuclear submarine overhauls is an acceptable site for new construction of nuclear ships. They reason that the public will not respond favorably to another nuclear worksite because of concerns for safety and the environment. One former high-level DOD official believes use of a private yard ought to be explored if another nuclear yard becomes necessary. Another expert suggests private management of a Navy-owned yard should it be used for new construction.

Starting up a third nuclear construction yard is a very complex issue on which high-level Navy officials differ. For example, despite DOD's position, the Naval Sea Systems Commander favors such action. Further, while the IDA study referred to by DOD did not show a clear requirement, it recognized that:

--The present nuclear industrial base will not be sufficient to handle (1) all three types of nuclear ships--carriers, submarines, and cruisers, (2) the increase in fleet overhauls during the mid and late 1980s, and (3) unexpected construction surges.

--There is some doubt as to whether the two private shipbuilders can hire and train enough workers (to achieve the buildup) as well as effectively manage such a large workforce. Both companies had trouble with such higher capacity during the 1970s claim's era.

--Private shipbuilders' uncertainties as to whether the planned ships actually will be procured is a disruptive factor that could affect (1) their investment decisions

on new construction techniques, (2) expected productivity, and (3) related IDA projections.

The IDA study recommended that the Navy explore how to expand its own nuclear overhaul capability so that the overhaul bulge of the mid-1980s will not affect private yard construction capacity. IDA also recommended that the Navy begin to build a reserve nuclear construction capability in one or more of its own yards.

Further reducing the strain on the nuclear industrial base is a fiscal year 1984 budgetary decision to drop construction of nuclear cruisers in the near-term and stretch out future nuclear submarine deliveries. These budgetary adjustments together with increasing the Navy's own overhaul capability are expected by some officials to negate the need for restarting submarine construction in a Navy-owned yard. Other officials contend the problem is not that serious because the Congress may not fund all the planned submarines.

Because of the interest in this matter, the Secretary of Defense advised congressional committees on October 13, 1982, that there was no current or near-term requirement for a third yard but recommended that this option be maintained on a yearly basis. The Secretary said further that he intends to reexamine this subject periodically to ensure the industrial base is maintained.

Our analysis

The question of whether naval submarine construction should be restarted, as Admiral Rickover suggests, is a close judgement call, made even more difficult by the absence of an agreed upon long-term shipbuilding program. A lot depends upon whether a congressionally funded buildup does occur and how extensive it is. Getting a Government yard back into the nuclear construction business would take considerable time and money. Before acting on this recommendation, we believe the Congress should have greater assurances of the need than it now has. Examples of events that might trigger such a need are:

- A national commitment to build nuclear ships at a rate greater than currently authorized. (As to the rate, a cross-over point according to the Navy's industrial base expert is four attack and one strategic submarine each year and two nuclear carriers every five years);
- A loss of present industrial capability through dedication to other work, natural disaster, or other cause, such as financial problems.

Matters for congressional consideration

The Committee should monitor the effects of the current buildup through (1) annual DOD assessments of existing nuclear industrial

base capacity and (2) actions needed to relieve the demand on and preserve the use of existing private yard capacity. These annual DOD assessments, which we are recommending on page 11, will become increasingly sensitive if a large congressionally funded buildup does occur. In such case the Committee would also need to scrutinize DOD actions to build reserve nuclear construction facilities and periodically consider the need for a privately or publicly managed third yard.

WITHDRAWING DOD SUPPORT FOR INDUSTRY-INITIATED RESEARCH AND DEVELOPMENT

Aside from regular contract work performed for the military services, private companies independently initiate research and development (R&D) projects to advance their technology and techniques, improve current products, and look for new ones. By law DOD may support such activities if they have military relevance. DOD provides support by accepting an overhead charge in its contract prices. The overhead charge varies from company to company and averages about 2 to 3 percent of the contract value.

Over the years Admiral Rickover has questioned the wisdom of DOD supporting these industry-initiated R&D projects, frequently referred to as Independent Research and Development. He has called it a "subsidy" and stated that DOD should spend the money directly on separate R&D contracts with direct control and supervision over the work. The Admiral also noted that:

- DOD gets no rights to patents and technical data evolving from a contractor's work, even when DOD finances most of it.

- DOD's financial support helps to perpetuate those companies already dominant in the defense industry because only those receiving defense contracts receive the support.

The Admiral was even more critical of the way DOD administered the program. He claimed that DOD evaluations, intended to help decide the level of financial support for contractors' R&D projects, are superficial because the evaluators have little knowledge, responsibility or incentive to challenge the projects. He said evaluators were allowed to grade their own competence to assess the contractor's projects. He noted other problems:

- Contractor descriptions of their projects are too vague and, therefore, difficult to evaluate.

- DOD's scope of operation is so vast that nearly any contractor technical activity could be construed as militarily relevant.

- DOD reviews of contractors' plans are not done in time to establish maximum dollar levels of support for the year under consideration. Therefore, previous years

results have to be used for succeeding years dollar levels.

Admiral Rickover's recommended solution

Admiral Rickover recommended that DOD support for contractor-initiated R&D be abolished or drastically cut back.

DOD's position

DOD disagreed and said it derived great benefit from industry's independent investment in R&D. DOD views the investments as seed money to foster research into areas of potential merit and develop technology for both existing and future defense needs at a reasonable cost. DOD noted that its share of contractor-initiated R&D was less than \$1 billion in 1981 out of a total of about \$3 billion expended by industry in this area. In other words, for only one-third of the cost, DOD says it has gained access to industry's entire effort, much of which DOD claims is militarily relevant.

DOD stated that (1) drastically cutting back or abolishing its participation would eliminate DOD's influence on industry's effort and (2) existing regulations and cost standards are sufficient for program monitoring. DOD also said the Navy is improving its communication with industry on military needs and its linkage of contractor results with Navy R&D planning.

Findings

During congressional hearings over the past decade, Government and industry experts have urged continued DOD support of industry-initiated R&D to provide a source of independent ideas, to advance technologies important to defense needs, and to further competition in the defense industry. These viewpoints were reaffirmed during our review.

The object of DOD policy is to maintain, in areas of defense interest, a capability in several or more firms to respond quickly, competitively, and creatively to emerging defense needs. The idea is to (1) encourage creative exploration of differing ways to meet military needs, (2) screen new technical concepts with minimum formality, and (3) eliminate all but the best before direct contract funding is required.

In addition to building technological strength and exploring innovative solutions to problems, industry-initiated R&D is intended to provide stability for key technical personnel in the face of uncertain and uneven defense funding. It also provides the opportunity for a firm to diversify its products and markets. The primary purpose from an industry viewpoint, however, is to put firms in a position technically to compete for future business.

Starting in the late 1960s a series of studies were made of industry-initiated R&D efforts. These studies, including some

reviews by this Office and the Commission on Government Procurement, culminated in joint hearings during the 1970s before Senate Armed Services and Joint Economic Committees. Although quantitative evidence was inconclusive, during the studies and hearings industry-initiated R&D efforts were generally recognized as being a normal cost of doing business and generally believed to be in the Nation's best interest to help develop competition advance technology, and foster economic growth.

The Chairman of the Senate Armed Services R&D Subcommittee concluded

It is the price we pay to make sure we have companies that are on the forefront of technology and prepared to bid on new projects. * * * If Congress were to become more involved in allocating these funds, it would mean that Congress would soon have to deal with choices as to which company should be proficient in which technology. Clearly, those decisions must be left to the individual companies. In my judgement the present system strikes a good balance between control and flexibility.

Government free use of inventions

Admiral Rickover has raised the question of whether DOD should have patent and technical data rights for successful research results, especially when most or all of the firm's costs are included in DOD contracts. The Admiral cites an example where:

One contractor developed at Government expense and patented an automatic welding machine. This was then marketed to defense suppliers and to Government installations. As it turned out, the Government paid not only for developing the invention but also royalties for the right to use it on Government work."

One Defense official stated that a change in policy might motivate some contractors to hide their new ideas until a defensible proprietary position can be developed. Other officials contend it is not equitable to charge the Government royalties for the use of inventions financed in large part under Government contracts. A military negotiator of industry R&D support agreements saw no problem in adding a provision to such agreements giving the Government free use of any inventions. According to one industry expert, however, this issue is not a major problem. He said companies doing mostly DOD work do not ordinarily develop patent rights. Electric Boat officials told us they would maintain an open mind on this issue as long as industry firms do not lose (1) their incentive to make inventions or (2) the competitive advantage derived from them.

Cost control

In the commercial marketplace, companies price their products to cover R&D costs. This is also the practice for products sold to the Government on a price competitive basis. In the defense and space industry, however, much of the contract pricing is not based on competition but on estimated or actual costs. Here, company-initiated R&D is treated as overhead and allocated to all customers.

The allocation is made without any guarantee that a particular customer will actually benefit from the future results. This is the way any indirect expense is allocated. For example, Army contracts can include R&D overhead that may ultimately benefit a new Air Force program. On the other hand, a commercial customer may receive an R&D overhead charge and may or may not benefit at all. For the larger contractors, a dollar ceiling to DOD participation is agreed to in advance. The degree of its participation is based on a number of factors such as (1) prior experience (2) DOD's assessment of the quality of the company's R&D projects, (3) responsiveness of the projects to future DOD needs, and (4) projected sales.

DOD technical personnel evaluate proposed costs, technical quality and potential military relevance of the projects. The technical review is based on annual contractor brochures, supplemented by DOD onsite reviews at least every 3 years. The purpose of the onsite reviews is to get a better understanding of the R&D projects in face-to-face discussions with the contractor's principal R&D investigators. Failure to reach agreement in negotiations results in a reduced ceiling. Failure to submit a proposal results in zero recovery. The contractor's incurred R&D overhead costs are reviewed by DOD contract auditors.

The extra costs of preparing the brochures, designed especially for these reviews, were roughly estimated by one industry expert to be in the \$100 million range annually. He states these extra costs are hidden in overhead and are over and above what management would normally incur. He prefers more frequent face-to-face exchanges of views. A military service R&D manager agreed with the \$100 million estimate but believed that most of the costs would still be incurred in internal planning documentation and external marketing of company developments.

In 1981 there were advance R&D overhead agreements covering some 221 companies or divisions doing business with DOD. Agreements are often for 2 or 3 years but may be reopened after the first year by either party if circumstances change drastically. The R&D amounts accepted in these agreements totaled about \$2 billion of which almost \$1 billion was allocable to defense contracts and the balance to commercial business. The DOD in-house cost of administering this program is not separately identified but is roughly estimated at several million dollars a year.

Our prior reviews have shown that industry-initiated R&D projects considered militarily relevant far exceeded the dollar ceilings that DOD usually accepted. 1/ The test of relevance has had no real impact because (1) DOD does not accept the full cost of contractor R&D programs, (2) DOD's scope of operations is quite broad, and (3) projects having no military relevance are relatively minor. The relevance test, therefore, does not really affect DOD's degree of participation in the contractors' overhead.

Admiral Rickover contends that small companies and those not in the defense business are handicapped by DOD support of industry-initiated R&D. However, Government support of a firm's R&D merely reflects that firm's relative size and competitive standing in the industry. There is opportunity for any size company which has established a competency in a defense-related area to receive a contract which includes DOD overhead support.

Small companies are subject to a formula approach permitting them to recover 100 percent of their expenditures except when their sales or expenditures vary widely from those of prior years. In that case, the small firm has the option of negotiating an advance agreement. Large contractors must negotiate advance agreements and the ceilings are generally below actual expenditures. To provide further assurance that small innovative companies are not neglected, a new law requires that agencies such as DOD set aside a certain number of R&D contract awards (Public Law 97-219).

Navy overhauling its program monitoring

Admiral Rickover's criticisms of program monitoring have been reinforced by a House Appropriations Committee Survey and Investigation report. For example, the Survey and Investigation team reported, as did the Admiral, DOD is not assuring that qualified evaluators are reviewing contractors' R&D projects. Each military service acknowledged the problem to the Committee staff. The Defense Under Secretary for R&D agreed during 1982 House Appropriations Committee hearings that "Defense's record has been spotty."

The Navy, in effect, has wiped the slate clean and designed a new monitoring program. It calls for:

- Shifting supervision from the more basic research side of the Navy house to the much larger material-management side where the ship, aircraft, missile, electronic and supply systems commands have much greater knowledge on future needs.

1/For example, "Contractors' Independent Research and Development Program--Issues and Alternatives" (PSAD-75-82, June 5, 1975, p. 36).

- Informing each company early in the year about new defense needs so that the Navy will be able to influence planned R&D projects, although the company will still have the final say over which projects it will undertake.
- Selecting from the mainstream of Navy systems commands a lead evaluator for each company (formerly reviewers handled as many as 35 companies each).
- Working with the DOD to revise the form for evaluating company R&D projects to (1) require a stated reason for rating a particular project either high or low and (2) eliminate consideration of project assessments by evaluators who believe they have only marginal competence in the field.
- Providing for the lead evaluator to participate in negotiating the company's overhead ceiling.
- Using multi-disciplined teams to provide stronger onsite evaluations of technical projects.
- Linking results of company-initiated R&D with planned Navy development programs.
- Setting up an overall program manager to be accountable for Navy monitoring.
- Funding the administrative effort necessary to support the program.

The Navy's new program has yet to go through a full cycle. Navy officials expect at least a 2-year shake-down period to get the program running smoothly. An issue raised by Admiral Rickover about synchronizing military service reviews is still unresolved at the DOD level. It is not clear whether contractor R&D plans can be submitted and reviewed in time to affect that year's dollar ceiling, rather than laying over the results to the following year.

Our analysis

The difference between Admiral Rickover's view and those of many others on this subject is to some extent explained by the Admiral's unique operating environment within the Naval Nuclear Propulsion Program. He controlled his programs from beginning to end, with continuous feedback from members of the operating fleet, many of whom he had personally selected for the program. This continuous feedback, plus a very strong technical capability from in-house personnel and the atomic energy laboratories enabled the Admiral to define the Government's needs, contract directly for the work, and continuously improve the product. However, in many military programs the technical competence resides for

the most part in industry. Therefore, DOD depends a great deal on technical opportunities and alternatives proposed by outside firms to complement and challenge its more limited in-house activities.

There is little or no civilian market for many DOD products and services and, therefore, industry cannot pass on its R&D costs to other than defense customers. Since industry technical competence exceeds that of the Government in many fields, denying Government support would limit the opportunity to innovate, restrain competition of ideas, and narrow the Nation's technology base. It can also be argued that the Government, like any other customer, should pay its fair share of these costs.

Contractor recoveries of R&D overhead are referred to by Admiral Rickover and other critics as "handouts". While DOD contractors are certainly not at the same risk as those in the commercial market, some risks still exist. For example, recoupment of these overhead expenses depends on the company's ability to receive contract awards for its products or services. If a contractor fails to sell its products or if its business base turns out to be less than anticipated, it may not fully recover the overhead.

An alternative to supporting this R&D effort through overhead is to increase contractor profits to cover the activity. However, by not reviewing this activity as a cost, DOD would lose visibility and influence over the activity. Another alternative would be to contract directly for the specific efforts involved, but this would result in direct Government control, not just visibility, over an otherwise independent source of ideas.

Although we believe DOD should continue to support industry-initiated R&D, we recognize that controlling the cost of such efforts in noncompetitive environments presents a difficult challenge. The most basic control, in our opinion, is self interest; if a particular firm in the defense business does not have a sound R&D program, its business will tend to erode and its financial base for future R&D recovery will weaken. Another constraint is the contractor's motivation to keep overhead cost at reasonable levels if the company's business has a substantial mix of commercial and fixed-price rather than cost-type contracts.

The most difficult problem of cost control of industry-initiated R&D is with those firms who have little or no commercial business with most of their Government contracts representing follow-on awards for items that cannot be recompeted. As Admiral Rickover suggests and DOD admits, the military relevance test is vague. Over the years most industry R&D projects have been found to be potentially related to a

military service function. The basic dilemma seems to be how to stimulate innovation in an unconstrained fashion but obtain reasonable assurance that the money is spent on something of national value as opposed to enriching a particular contractor.

In those instances where a contractor's business is largely noncompetitive, the contractor may need an incentive to make the best choices of R&D projects and manage them effectively. One incentive is for the contractor to have a personal financial stake, 20 percent for example, in the costs of each R&D project funded within the dollar ceiling. Such an investment would be less than one percent of the contract value 1/ and would seem preferable to relying too heavily on the quality of the contractor's brochures and Government monitoring.

Matters for congressional consideration

The Committee should ask DOD to:

- Closely monitor the Navy's revised program and have an outside panel of experts later on independently assess DOD's overall program effectiveness. The assessment should include a sampling of industry-initiated R&D activities to determine if the expenditures are for the purposes intended and if the military services' monitoring programs are being run effectively. 2/
- Include in DOD agreements which support contractor-initiated R&D activities a provision giving the Government free use of any inventions derived.

1/This contractor R&D activity averages about 3 percent of the contract value. Twenty percent of that would be 0.6 percent or less than one percent.

2/For some basic issues and questions to be considered in such an assessment, see the DOD-NASA Independent Research and Development Program: Issues and Methodology for an In-Depth Study, National Academy of Sciences, National Academy Press, Washington, D.C., 1981.

CHAPTER 3

CONDUCT OF PROCUREMENT

Admiral Rickover recommended several changes in the procurement process. The basic theme of these recommendations is that the Government needs to modify its procurement policies and practices to use more leverage and good business judgment and be a more demanding customer in its dealings with contractors. Specifically, the Admiral would

- require that DOD use the leverage of what might be procured in the budget to get sole-source contractors to agree to more suitable contract terms and conditions,
- not rely heavily on special financial incentives in place of good management to get contractors to perform efficiently,
- provide statutory authority to avoid accepting unrealistically low offers that would likely result in injury to the Government, and
- like to see more effective use of the contract award process to influence contractors to correct their performance problems.

REQUIRING DOD BUDGET CERTIFICATION ON TERMS AND CONDITIONS

Admiral Rickover is concerned that once the Congress authorizes and funds a ship, the Navy is under great pressure to get the contract awarded; this, in turn, leaves sole-source shipbuilders in a strong bargaining position because the Navy has little or no remaining leverage in contract negotiations. He believes that, as a result, the Navy has experienced great difficulty in some cases in trying to get sole-source suppliers to agree to terms and conditions necessary to adequately protect the Government against after-the-fact claims. He cited these examples in his May 1981 testimony:

- Electric Boat used its sole-source position on Trident submarines to exact Navy agreement to pay the premiums for an insurance policy from Lloyd's of London to cover the risk of its own defective material and workmanship.
- Electric Boat also insisted on a loophole in the Navy's "Notification of Changes" clause preserving for the company the ability to generate large claims years after the fact, exactly the opposite of what the Navy wanted to accomplish with the clause.
- Newport News insisted upon and obtained, in a contract for a nuclear aircraft carrier (CVN-71), a special

clause under which the Government must adjust the contract price for delays caused by energy shortages, a clause not generally given to other contractors.

- The ordering of long leadtime materials for construction of the aircraft carrier was delayed about 4 months before the Navy was finally able to get Newport News' agreement to comply with the requirements mandated by the Congress for certification of claims.

Admiral Rickover stated that outstanding business issues should be taken up with major defense contractors during the budget process and resolved before DOD sends its budget request to the Congress. If DOD needs help from the Congress, it can request it at that time. Admiral Rickover added:

"Congress has an oversight responsibility to ensure that public funds are spent wisely. If Congress feels that the Department of Defense has not obtained adequate protection against after-the-fact claims or if the shipbuilder refuses to agree to the terms and conditions, Congress can use the authorization and appropriation process as leverage to obtain compliance."

Admiral Rickover's recommended solution

To provide the Government with leverage in dealing with sole-source contractors, the Congress should require the Secretary of Defense to certify, in support of budget requests, that he has obtained contractor agreement on suitable terms and conditions. This should include terms that would provide appropriate protection against after-the-fact claims if the proposed program is funded. DOD would be able to present the facts to the Congress and seek legislative assistance, if it were unable to get appropriate contractor assurances on an important program.

DOD's position

DOD officially disagreed and stated that the recommendation is impractical. Among the reasons given for this position were:

- Such agreement with a contractor prior to congressional authorization and appropriation would prejudice congressional action.
- The Congress already has sufficient opportunity to be assured that suitable terms and conditions are being obtained prior to contract award through the Navy business clearance review and Chief of Naval Material approval, congressional notification, and hearings.

- Agreement between the Government and the contractor on suitable terms and conditions would require the preparation of a contractor proposal and negotiation of that proposal. These negotiations would be taking place 2 or 3 years before the parties could consummate a contract and the contractor would have to include significant protection or contingencies (price and other factors) to offset a dynamic marketplace.
- Final negotiations at the time of contracting would be required and changing circumstances may modify prior agreements. Thus, the recommendation would require duplicate and unnecessary expenditure of effort on the part of both parties.

Findings

This recommendation is intended to settle major unresolved issues relating to contract terms and conditions excluding price, which would have to be agreed upon during normal contract negotiations. The recommendation implies that if suitable terms and conditions are not agreed upon, the ships may not be procured, at least not in the same quantity or time frame, as was contemplated.

Navy officials we interviewed rejected this recommendation as impractical or unrealistic because they believe that:

- The Navy could not afford all the contract clauses it would like to have; contractors could want enormously increased prices to compensate for the additional risks for which they would be responsible.
- Circumstances change and these changes would affect agreed-upon terms and conditions. Thus, agreements would have to be renegotiated.
- Admiral Rickover's approach to the contractors is adversary in nature and will not result in avoiding claims problems. Instead, the Navy is trying to maintain a cooperative business relationship based on equitable contracts to achieve this same objective.
- As a result of this Navy approach, the era of huge contractor claims has passed.
- National defense requirements, not contract negotiations, should decide what ships are requested in the budget. If Admiral Rickover's approach is used, contractors are often likely to be effective politically in getting the ships into the budget anyway.

--Rather than expediting the process, a requirement for certification of agreement on terms and conditions could delay budget submission.

The House Committee on Appropriations' Survey and Investigation Staff investigated the Navy's authorization of insurance costs covering a shipbuilder's defective workmanship and material as allowable overhead on contracts (see the first example cited on p. 24). The Committee staff report concluded that (1) the Navy's action was inconsistent with the general and historical Government policy of having the Government serve as its own self-insurer and (2) if such anomalies persist, the initial acquisition price of ships will rise dramatically and procurement practices inimical to the best interests of DOD will be established.

The Navy disagreed that its action was inconsistent with the general and historical policy, but noted that congressional action has since restricted the use of future appropriated funds to pay for the type of insurance covered by the agreement cited.

Our analysis

This recommendation was prompted by Admiral Rickover's belief that there is insufficient coordination between business matters, such as terms and conditions which affect fundamental relationships with contractors, and budget decisions on what DOD should buy and when. In addition, he believes that a budget submission generally locks the executive branch into fighting for budget items as vitally necessary for national defense, and this can leave the Government with little or no leverage for getting sole-source contractors to agree to suitable terms and conditions. Once the need for ships has been justified to and funded by the Congress, the Navy would naturally want to contract for them.

We agree that it is a desirable objective to improve the Government's bargaining position through better coordination between business and budget matters, especially when the Government lacks sufficient leverage to obtain equitable terms and conditions because of a sole-source situation. However, we believe it would be too cumbersome to require the Secretary of Defense to certify contractor agreement on suitable terms and conditions in budget submissions, as Admiral Rickover recommended.

In our discussions with DOD officials we also explored whether a less formal approach might more readily improve DOD's coordination of business and budget matters. Some officials stated that surfacing such business problems at a high level could be effective if used selectively for important issues relating to anticipated sole-source contracts on critical programs. That is, discussions between high-level Government and contractor officials on important unresolved business issues

could be initiated prior to budget submission to increase Government leverage in gaining contractor agreement on suitable terms and conditions. This approach could also save valuable time in negotiations and permit earlier starts in ship construction. If such agreement cannot be reached, DOD could seek congressional assistance, either formally or informally.

We agree that this less formal and more selective approach is reasonable. We believe its use should be considered by DOD officials in special situations if the issues are important and could have significant dollar implications, such as a contractor seeking Navy agreement to pay insurance premiums for defective contractor workmanship and material. (See pp. 24 and 27.)

Matters for congressional consideration

The Committee should encourage the Secretary of Defense to:

- Have high-level DOD officials hold discussions with contractor officials prior to budget submission on important unresolved business issues relating to expected sole-source contracts for critical defense programs.
- Specifically address important unresolved issues, especially on major shipbuilding contracts, as part of DOD's prepared statements in testifying on the budget or in other communications with congressional committees when he deems it appropriate.

DOD comments and our evaluation

DOD stated that it was appropriate we did not agree with Admiral Rickover's recommendation on certification of suitable terms and conditions. However, DOD interpreted our draft report's suggested "matters for congressional consideration" as a requirement to be imposed on DOD by the Congress to resolve those terms and conditions. In DOD's view the time phasing between budget formation and contract negotiation does not permit this approach. This DOD interpretation is contrary to our intent. Therefore, we have clarified the wording of this section to encourage a flexible approach based on the judgment of top DOD officials.

NOT RELYING HEAVILY ON SPECIAL FINANCIAL INCENTIVES AND BONUSES

Admiral Rickover agrees with the current Navy policy of using fixed-price incentive contracts in its shipbuilding programs for other than the initial ships of a class. But he criticized the use of "special financial incentive and bonus" provisions. These contract provisions offer contractors additional payment beyond that required in the basic fixed-price incentive contract for either early delivery or better technical performance. Special incentives were used, for example, to

encourage early delivery on nuclear aircraft carrier and ship overhaul contracts. Admiral Rickover has criticized the Government for making a grave error when it relies on these contractual provisions as a substitute for good management. However, he is not necessarily opposed to the use of special incentive provisions if they are structured properly. For example, he believes the Government should have to pay the extra delivery incentive or bonus only to the extent that earlier delivery, as originally agreed, (and the accompanying savings) has been achieved.

Admiral Rickover stated that:

"Past experience in the shipbuilding industry shows that these (special financial incentives and bonuses) have not worked and that the Navy has ended up paying more without actually improving performance. Instead of spurring improved performance, financial incentives have in the past merely prompted contractors to try to qualify for the bonus, regardless of performance, by holding out in negotiations for higher target costs and extended delivery schedules. During performance of these contracts, there is a greater incentive to create bases for subsequent claims -- again to try to qualify for the bonus even if the ship is late or exceeds the original target cost."

Admiral Rickover's comments in an October 29, 1981, memorandum to the Commander, Naval Sea Systems Command, illustrate his concerns. At that time the Command was negotiating with Newport News to deliver the CVN-71 nuclear aircraft carrier approximately one year prior to the contract delivery date. Admiral Rickover stated that:

--Under the proposed special incentive arrangement, the Navy and Newport News would share the savings, such as avoidance of economic escalation, that would be achieved because of early delivery. There is nothing wrong with the concept of sharing any ensuing cost savings with Newport News, if it meets the earlier date. However, if the target delivery date is to be adjusted for contract changes, defective Government material, etc., as the contractor has insisted, the Navy will run the risk of being flooded with claims for alleged delay to the target schedule.

--This is what actually happened when the Navy incorporated delivery incentive provisions on submarine contracts during the 1960s. Some shipbuilders, to preserve their rights to the delivery incentive payment, would claim delivery impact on even minor changes, which did not in reality create a problem. In some cases, the Navy ended up paying bonuses for ships delivered later than the original target date.

--Earlier delivery on the CVN-71 carrier already offers Newport News an opportunity for savings and extra profit, apart from the proposed incentive provision. Therefore, if Newport News insists on reserving the right to submit claims for adjustment of the target delivery date, the Navy should abandon the special incentive payment scheme. It is not worth saddling the Naval Sea Systems Command with the potential of years of haggling over the alleged delivery impact of changes, deficiencies in Government-furnished materials, etc., which will inevitably arise during the remainder of the CVN-71 carrier building period.

In spite of Admiral Rickover's warning, the contract was modified in December 1981 to include provisions for an additional incentive payment for early delivery and possible adjustments in the December 1986 target delivery date.

Admiral Rickover's recommended solution

Senior DOD officials should not rely heavily on special financial incentives and bonuses to entice contractors into performing efficiently.

DOD's position

DOD responded that:

- Incentives (whether on performance or cost or both) in properly constructed contracts are excellent ways to assure that the quality of the product desired can be obtained at controlled and manageable costs. Performance and cost incentives have worked and are presently working in numerous Navy contracts. Shipbuilders, in particular, have increased or decreased their fee or profit due to their performance.
- Negotiation of the contract targets is extremely important for incentives to be effective. Contract changes can reduce or eliminate the range of incentive effectiveness established by the original negotiations since the targets and schedules can be subject to revision with contract modifications.

Findings

In general, Navy officials interviewed expressed strong support for the use of fixed-price incentive contracts for other than lead ships of a class. When we explained that Admiral Rickover's objection to "special financial incentives" is related to delivery or technical performance incentive provisions beyond the basic fixed-price incentive contract, Navy officials and others generally agreed that these special incentive provisions can be easily misapplied and that much

care is needed in structuring them properly. The Commander, Naval Sea Systems Command, admitted that the Government almost never gets the advantage out of these special incentives. One program manager stated that (1) a reasonable fixed-price incentive contract provides the contractor with enough incentive to perform efficiently, and (2) the requirement for equitable adjustment of targets and milestones in special incentive provisions makes contract administration next to impossible. Although all of these officials recognized that there are disadvantages or pitfalls in using special incentives, most stated that their use should not be ruled out and that they might be useful in certain situations.

The results of research studies by others also raise questions as to whether such incentives motivate contractors to perform better. One defense expert said that use of special incentives may help communicate to contractors what the Government's priorities are, but he does not expect much else from them. He stated, and others who have studied the use of incentives agreed, that such provisions should not be relied on because research shows that incentive provisions may have little or no real incentive effect; instead, the prospect of future contracts is the best incentive. Those who had studied the use of such incentives specifically agreed with Admiral Rickover's statements that reliance on good management instead of such provisions was needed. They suggested that good management would include resisting nonessential contract changes and communicating well and often with the contractor.

On the other hand, Newport News stated their belief that special financial incentives (1) are in the best interest of the taxpayer, (2) should continue, and (3) are far more motivating to a contractor than the inadequate profit margins allowed by Admiral Rickover when he was in charge of Naval Nuclear Propulsion.

Our analysis

There are some differences but much common ground between Admiral Rickover and most Navy officials and others we spoke with on this issue. Although Admiral Rickover objected to heavy reliance on special incentives, both he and most others we interviewed recognized that such incentives could be useful if "structured properly." There was also widespread agreement that there are pitfalls in using such incentives because (1) targets, such as the delivery dates on delivery incentives, must be realistic for the incentive provisions to be effective but can be very difficult to set and (2) special incentives with adjustable targets make contract administration extremely difficult when late Government-furnished equipment or design information or contract changes occur, which they frequently do in shipbuilding. These factors result in a high potential for contractor claims based on the allegation that the Government was

responsible for the failure to achieve the target. In these situations there are risks of:

- The contractor getting paid the additional incentive despite the failure to achieve the original target because of Government-caused delays or other problems.
- Large claims, disputes, and contentiousness not only adversely affecting the business relationship between the contractor and the Government but also using up valuable time and effort on both sides.
- The Government relying too heavily on incentives to achieve program results.

A major difference of opinion between Admiral Rickover and others on this issue relates to the contract provisions for equitable adjustment of targets associated with the special incentives. Admiral Rickover has favored the use of additional delivery incentives only if the target dates were not adjustable. He has indicated that only under this condition does the Government have reasonable assurance that it will benefit from payment made under these provisions. Some Navy officials believe equitable adjustment is necessary because the contractor should not lose the incentive payment if the Government was actually responsible for the failure to achieve the target.

We believe that this question needs to be decided case-by-case based on the particular circumstances. We also believe that Government officials need to realistically assess the chances of achieving the targets as well as the likelihood of the Government being held responsible for not achieving them because of such problems as late or defective Government-furnished equipment or design information.

As previously noted, DOD's position recognizes that contract changes can reduce or eliminate the effectiveness of incentives based on adjustable targets. Yet, contract changes are very prevalent in shipbuilding because of the complex nature and length of the shipbuilding process as well as other factors, such as the need for shipboard integration of many weapon systems. These conditions make shipbuilding unique and demonstrate the need to exercise extreme care in the use of special incentive provisions on shipbuilding contracts.

More importantly, we agree with Admiral Rickover that Government officials should rely on good management instead of special incentives to ensure that important program objectives are met.

Matters for congressional consideration

The Committee should require the Secretary of Defense to develop a policy limiting the use of special incentive

provisions by specifying the conditions under which they may be appropriate.

DOD comments and our evaluation

DOD stated that it does not object to trying to establish if specifiabile conditions exist under which special incentives may be appropriate. However, it believes that developing a policy (1) is premature until such conditions have been shown to be identifiable and (2) will only lead to unnecessary and unworkable constraints on the negotiating process. Instead, DOD suggested that it should be asked to study and consider the advisability of developing such a policy."

We disagree because we believe our analysis and findings sections have identified certain conditions that need to be avoided when special incentives are used. These conditions include late or defective Government-furnished equipment or design information and other contract changes. As noted earlier, DOD has already recognized the adverse effects of contract changes on the effectiveness of these incentive provisions; yet such changes are quite prevalent in shipbuilding. We believe that setting forth a policy specifying the known conditions under which special incentives may be appropriate could be helpful in limiting the use of special incentives.

AWARDING CONTRACTS TO OTHER THAN THE LOW OFFEROR

Admiral Rickover stated his views on the need for legislation to avoid buy-ins ^{1/} and other unrealistically low offers in May 1981 congressional testimony:

--The Navy normally relies on competitive bidding of fixed-price negotiated contracts whenever more than one contractor can build the ships needed. However, the competitive bidding system in shipbuilding is being subverted by repeated underbidding and subsequent attempts to recover losses through claims.

--The underlying premise of competitive bidding is that over the long run an efficient company will reap rewards in the form of more business and higher profits while

^{1/}The Defense Acquisition Regulation defines a "buy-in" as the practice of attempting to obtain a contract award by knowingly offering a price or cost estimate less than the anticipated costs with the expectation of (1) increasing the contract price or estimated cost during the period of performance through change orders or other means or (2) receiving future "follow-on" contracts at prices high enough to recover any losses on the original "buy-in" contract.

inefficiency will lead to declining business and losses. In naval ship procurement, however, this premise has not been holding true.

- There have been two shipbuilders in the Navy's SSN-688 class submarine construction program. Although Newport News has been by far the more efficient of the two shipbuilders, Electric Boat has won contracts for more ships.
- Despite past performance, Electric Boat always seems in a position to be the low offeror, simply by projecting future productivity improvements. For example, after the 1978 Public Law 85-804 extra-contractual claims settlement, Electric Boat again underbid Newport News for two SSNs the Congress authorized for fiscal years 1978 and 1979. The Navy informed Electric Boat that the company's offer was considered to be unrealistically low; Electric Boat insisted it was not. Although officials of the Naval Sea Systems Command were convinced that the Navy would ultimately save money on these ships by awarding to Newport News, Navy lawyers advised that the contract had to be awarded to the low offeror, Electric Boat. Apparently, Electric Boat's bidding tactics were aimed at trying to force Newport News out of the business.
- In an effort to sustain a submarine construction capability at Newport News in the face of Electric Boat's aggressive and unrealistic bidding, senior military officials on two separate occasions in 1979 sought Secretary of the Navy approval to allocate the Navy's next SSNs to Newport News. In both cases the request was disapproved and Electric Boat once again submitted the low offer. Upon taking office, the current Secretary of the Navy recognized the need to keep Newport News in the submarine construction business and authorized sole-source negotiations with that yard. This action kept the Navy's most efficient yard building submarines.

Admiral Rickover concluded that:

"This experience highlights the need for statutory or regulatory authority that will enable the Navy to frustrate a buy-in attempt by rejecting an unreasonably low bid* * * * By consistently underbidding its more efficient competitor, and then failing to perform as predicted, Electric Boat has caused the Navy no end of problems. Ship deliveries have been years later than at Newport News. Construction delays have tied up scarce Navy crews uselessly at the shipyard awaiting ship delivery. By depriving Newport News of submarine business the Navy is having to pay for a costly break in production at Newport News. Moreover, through claims,

Electric Boat has been able to pass on their own higher costs to the Navy, thus erasing completely any apparent cost savings arising from having awarded these contracts to the low bidder."

Admiral Rickover's recommended solution

The Congress should pass legislation providing explicit authority for DOD to award contracts to other than the lowest bidder in cases of an apparent buy-in attempt, or when the Secretary determines that award to other than the lowest bidder would result in cost savings to the Government.

DOD's position

DOD's response to this recommendation noted that when a buy-in is suspected, the contracting officer must ensure that the contractor can sustain a loss and will not recover through change orders. DOD acknowledged that legislation is required to allow formally advertised awards to other than the low responsive and responsible bidder. However, regarding Admiral Rickover's real concerns over negotiated contract awards, DOD stated that (1) the law allows negotiated contract awards based on price and other factors; (2) the evaluation criteria used to select the winning contractor on negotiated contracts are structured to maximize the impact of technical approach, past performance, and cost realism instead of primarily cost and this approach minimizes the effect of a low-cost proposal or an attempted buy-in; and (3) award to other than the low bidder is already permitted, since most major weapons systems' contracts are negotiated using a comprehensive source selection procedure.

Findings

Some knowledgeable DOD officials stated that DOD has all the authority it needs on negotiated contracts, including those for nuclear submarines, to award to other than the low bidder in almost every situation. That is, by properly structuring multiple evaluation criteria to be used in source selection, the unrealistically low bid can be avoided. They cited several examples of Navy procurements on which this approach had been used, including fixed-price, as well as cost-type contracts. However, they admitted that this approach would not always solve the problem because buy-ins cannot always be predicted. One contracting official added that (1) the evaluation criteria for each contract need to be carefully considered to permit award on the proper basis and (2) Navy officials have not always done this; instead the solicitation provisions of prior contracts, such as evaluation criteria based primarily on price, have sometimes been adopted without considering the likely consequences.

Others noted that the Naval Sea Systems Command's use of steeper (50/50) share lines on its fixed-price incentive

contracts ^{1/} should encourage more realistic estimates and may increase the risks of underbidding to contractors. However, again they noted that this approach would not eliminate the problem.

Some Navy officials stated that the appropriate remedy to the buy-in problem is:

- Good business judgment, which includes using appropriate source selection evaluation criteria, as previously discussed, and a sound procurement strategy.
- Good contracts, consistent with the nature of the risks involved, which provide a greater likelihood of receiving a quality product, on time, and within the expected cost or price.
- Good contract administration, including properly pricing out the contract modifications for what they are worth.

They concluded that legislation giving DOD additional authority is not needed because DOD chooses the wrong contractor and suffers bad effects from a buy-in only in "isolated cases." They also noted that use of such authority may be controversial because Government cost estimates are not always accurate.

Admiral Rickover agrees that this problem does not occur frequently but noted that the dollars and problems involved can be very substantial when it does occur, such as on the SSN-688 program. Therefore, he believes statutory authority is needed.

Some knowledgeable individuals both inside and outside DOD agreed with Admiral Rickover's recommendation and stated:

- Authority is needed by someone, such as the Department head, to allow award to other than the low bidder in cases of an "apparent buy-in."
- Although the quality of Government cost estimates has greatly improved over the past decade, without such authority it is impossible to sufficiently prove to decisionmakers that an offer is unrealistically low.
- Source selection evaluation criteria not directly related to cost or price are normally important only in awarding cost-type contracts. Since the Navy uses fixed-price incentive contracts after the early ship(s) of a class, lowest price will continue to dominate contract award decisions for constructing ships based on more mature

^{1/}A 50/50 share line provides for equal sharing of underruns and overruns up to an agreed-upon ceiling level.

designs, unless additional authority is given to decisionmakers.

In 1980, a high-level Ship Acquisition Policy Advisory Council reviewed the proposed Naval Sea Systems Command actions on the 1978 Naval Ship Procurement Process Study. The study was intended to correct problems which had resulted in the serious ship claims situation of the 1970s. The Council:

- Noted that DOD policy and procurement regulations do not prohibit buy-in proposals in fixed-price contracting.
- Agreed with the study conclusion that buy-in contracts can breed an environment particularly suited to generating future claims.
- Stated that the basic problem is the Navy's inability to prevent shipbuilding buy-ins of genuinely harmful proportions partly because of the lack of adequate procedural and regulatory guidance.
- Directed that appropriate regulations, definitions, and procedures governing buy-ins be drafted.

However, a Naval Sea Systems Command contracting official told us that procedural and regulatory guidance specifically governing buy-ins was not developed because the Command concluded that adequate protection was available.

Our analysis

We agree that in many cases awarding to a firm that is buying-in is not likely to injure the Government. In these cases the current DOD policy of ensuring that the contractor can sustain a loss and will not recover through change orders or noncompetitive follow-on contracts appears to be adequate. However, the existence of special circumstances in the type of buy-in situation Admiral Rickover was most concerned about needs to be taken into account:

- There is a very narrow competitive base, such as only two sources, available for a critically needed item and these sources are all considered responsible and have proven technical ability to do the work.

- There is a belief that price should be heavily emphasized in the source selection evaluation criteria because of the maturity of the product or system design. 1/
- The Government cannot be assured of being able to reasonably limit contract changes because of such factors as (1) the lengthy and complex nature of the shipbuilding process, (2) the uncertainty involved in national security requirements, and (3) possible technological changes.
- Past performance and other evidence may or may not indicate the likelihood of a buy-in in these circumstances but it is usually difficult or impossible to prove.

To understand the problem Admiral Rickover is addressing, it is also helpful to review the SSN-688 class submarine construction program's acquisition history, including the Navy's use of a dual sourcing acquisition strategy. (See app. III.) This material raises a question as to why the Navy did not adhere to its original dual sourcing strategy by favoring split awards between the two sources. In particular, the 1973 decisions to award all 11 ships to one source seem to have put the potential short-term benefits of promised lower prices ahead of the long-term benefits of maintaining two competitive and reasonably balanced sources. The short-term benefits proved to be illusory and the imbalance created by this action set the stage for further problems in the future.

Navy officials suggest that the buy-in problem can often be avoided by properly structuring the source selection evaluation criteria to emphasize important considerations other than cost or price when a buy-in is anticipated. However, they admit that it is not always possible to anticipate a buy-in. The question remains controversial whether evaluation criteria can be used effectively to avoid buy-ins harmful to the Government in the type of fixed-price, mature program situation to which Admiral Rickover referred. But the question is moot since there is a consensus that not all harmful buy-ins can be avoided in this manner.

Although we believe the present law provides sufficient authority, there is still a policy question concerning how to best ensure that the Government is protected against a buy-in. This policy question is particularly important because, as a practical matter, it has been historically difficult for agency

1/Unrealistically low estimates or buy-ins are also generally considered to be a problem on cost-type research and development contracts. However, in these cases non-cost evaluation criteria are predominant and cost normally becomes the critical award factor only when the evaluation of other factors is fairly equal.

officials to structure awards for mature programs so that a substantially lower price, even if unrealistic, offered by a technically capable and responsible firm, is not the dominant award factor. For example, we believe it is significant (and the record of the SSN-688 program during 1979 and 1980 demonstrates) that there is no assurance higher agency officials will approve the evaluation criteria or procurement strategy proposed by contracting and legal experts to avoid a possible buy-in. In late 1979, the Naval Sea Systems Command developed and proposed using evaluation criteria designed to protect the Navy against deliberate underbidding on the SSN-688 program. However, higher Navy officials rejected the approach. According to the former Commander, Naval Sea Systems Command, these officials indicated that they preferred basing the award solely on the lowest price submitted, although they conceded that the proposed approach was perfectly legal. 1/

The Defense Acquisition Regulation provides that when a buy-in is suspected, the contracting officer must ensure that the contractor will not recover through change orders, noncompetitive follow-on contracts, etc. However, the regulations do not provide for those situations where adequate assurance of this type does not exist, including long-term shipbuilding contracts. We agree that buy-ins should be handled as the regulation suggests, if there is adequate assurance that the contractor can be prevented from recovering at the Government's expense. However, when such assurance does not exist, we believe additional regulatory or statutory authority is needed to give agency decisionmakers more discretion to avoid apparent buy-ins or other unrealistically low offers which are likely to be harmful and more costly to the Government.

Therefore, we believe that Department heads should have the authority to award contracts to other than the low-price offeror when in their judgment:

- The Government does not have adequate assurance that it can prevent the contractor suspected of underbidding from recovering at the Government's expense through contract changes or noncompetitive follow-on contracts; and
- Acceptance of another offer is more likely to result in a lower final cost to the Government. Prior procurement experience under the program involved as well as Government cost estimates may help in making such determinations.

We believe that this authority should not be delegated more than one level below the agency head. Secretarial certification to

1/Also, see the discussion of senior military officials' suggestions relating to SSN-688 procurement strategy on page 34.

the Congress justifying use of this authority should also be required if legislation is enacted.

Some contend that such authority could be abused. For example, Electric Boat officials expressed this view. We believe use of this authority would likely be infrequent, since (1) only the highest agency officials could exercise it and (2) its very existence should discourage buy-ins. Although there is some risk of misuse, we believe that the public visibility such actions would likely receive and the availability of various bid protest remedies to contractors make such a risk reasonable. This is especially true when the risk of misuse is compared to the risk of buy-ins injuring the Government, for which no remedies are available. In addition, Secretarial certification to the Congress would further discourage misuse of this authority.

We believe such authority could have the additional benefit of encouraging more cost realism in contractors' proposals. Some experts in this field believe that Government officials are naive at best when instead of encouraging cost realism, they (1) induce contractors to underbid to receive awards in a type of cut-throat competition, and then (2) criticize them for taking advantage of contract changes to recover. Fostering realistic cost or price proposals would be an important benefit of this recommendation.

DOD's efforts to increase the use of dual sourcing in the production phase make this recommendation timely and give it added importance.

However, even with this additional authority sound procurement planning is essential. Agency officials must use procurement strategies and source selection evaluation criteria that minimize the likelihood of expected buy-ins that would injure the Government.

The present law provides authority to accept other than the low-priced offeror in negotiated procurements. Thus, we do not see any reason why the additional authority cannot be provided by regulation. In fact, we believe this approach could have certain advantages. For example, it would give greater flexibility for making any needed future improvements in the provision and could likely be accomplished more quickly than enacting legislation. However, a statutory amendment may be preferable for policy and practical reasons. That is, statutory authority would provide more inducement and protection to agency officials who believe use of this authority is appropriate, although controversial. In any case, whether the authority is provided by regulation or statute, we believe a solicitation clause should give notice to potential offerors that the agency head has such authority to reject low offers judged to be injurious to the Government.

Matters for congressional consideration

The Committee should either propose legislation amending the Armed Services Procurement Act ^{1/} or ask the Secretary of Defense to modify the Defense Acquisition Regulation authorizing the award of contracts to other than the low offeror when in the judgment of the department head these conditions exist:

- The Government does not have adequate assurance that it can prevent the contractor suspected of underbidding from recovering at the Government's expense through contract changes or noncompetitive follow-on contracts; and
- Acceptance of another offer is more likely to result in a lower cost to the Government.

If legislation is enacted, the Department head should be required to justify any use of this authority through certification to the Congress.

DOD and contractor comments and our evaluation

DOD disagrees and believes that it has all the authority it needs to accept other than the lowest-priced offers in negotiated procurements. Electric Boat also stated that it believes the Government already has all the power it needs to avoid buy-ins.

We agree that authority exists under current law to award negotiated contracts to other than the low-priced offeror. However, this report is focusing on a special problem relating to agency awards of fixed-price contracts on mature programs where for practical reasons price tends to dominate the selection decisions. We do not believe that DOD's or Electric Boat's comments adequately address the specific problem we are addressing. As noted earlier in our "analysis" section, it is a practical policy problem rather than a strict legal question.

Newport News stated that DOD already awards some contracts to other than the low offeror. To illustrate this, Newport News noted that on a recent award for construction of two submarines it offered the lowest price but its competitor received the award. Newport News said it does not see any need for the statutory authority if DOD believes they do not need it.

We do not believe that Newport News' illustration is relevant to the specific problem being addressed. Navy

^{1/}The Congress should also consider the option of adding such a provision to "The Competition in Contracting Act," an existing bill to strengthen competition under this Act.

officials, including the contracting officer on the award, informed us that (1) neither competitor offered a price the Navy considered to be unrealistically low, (2) the prices offered by the two competitors were, in fact, so close that this factor was evaluated as equal, and (3) therefore, the other factors, delivery schedule and prior performance, determined the winner.

In addition, DOD noted that if we believe current authority is inadequate, we should recognize that buy-ins (1) apply to the entire Federal Government and (2) should be corrected at that level. Therefore, DOD suggested that the Office of Federal Procurement Policy, instead of DOD, be requested to review this subject and submit a legislative amendment, if necessary.

We agree with DOD that the buy-in problem occurs Government-wide. We believe it is also likely that the type of buy-in we are discussing in this report, which is very costly and harmful to the Government, occurs in Federal agencies besides DOD. However, we believe it would be helpful to test the exercise of this special authority in DOD, where the most costly examples of these problems have occurred, before considering whether it should be expanded to other Federal agencies.

NOT TOLERATING POOR CONTRACTOR PERFORMANCE

Admiral Rickover stated in his January 1982 testimony that:

- During the past decade Navy shipbuilding has been plagued by contractor inefficiencies which have resulted in cost overruns, failure to meet delivery schedules or quality requirements, and contractor attempts to shift these problems to the Government through inflated claims and threatened work stoppages. These problems will inevitably recur.
- DOD officials encourage poor performance, buy-ins, and claims in the future when, to resolve a dispute, they settle claims for more than the Government legitimately owes.
- The current Secretary of the Navy should get higher marks than his predecessors for insisting that General Dynamics not be awarded more Trident or SSN-688 class submarine construction contracts until that company abandons its so-called "insurance claims" to recover the cost of correcting its own defective workmanship.

In other testimony, Admiral Rickover specifically advocated holding up the award of ships to particular contractors until contractual arrangements adequate to protect the Government's interest could be agreed upon.

Admiral Rickover believes that not tolerating poor performers is basic common sense. He would like the Government

to increase its use of contract award decisions as leverage to get contractors having serious performance problems to correct them not only on proposed work relating to contracts about to be awarded, but also with respect to ongoing work under contracts previously awarded.

Admiral Rickover's recommended solution

DOD should not tolerate contractors who, through their own inefficiency, incur cost overruns, fail to meet delivery schedules or quality requirements, and try to shift these problems to the Government through inflated claims and threatened work stoppages.

DOD's position

DOD responded that (1) the principle of considering a contractor's performance in awarding new contracts and continuing existing contracts is well established by policy and regulation and "is operative," (2) this principle goes to the very heart of the complexity of Government contracting and the degree of success that can be achieved is in direct correlation to the Government's ability to manage its contracts, and (3) the decision process in determining whether to award a new contract or terminate an existing one takes into consideration a multitude of factors, including

- the urgency of need for a particular product,
- the industrial base,
- the need to obtain or retain sources for purposes of competition,
- the degree of Government responsibility, and
- the contractual and legal risks associated with a decision not to contract or to terminate a contract.

Findings

As used in this report, the term "prior performance" refers to contractor performance on previously awarded contracts which is relevant to a source selection decision, including current performance under ongoing contracts.

DOD officials interviewed were overwhelmingly in favor of giving more emphasis to prior performance in source selection decisions, as a means to avoid awarding contracts to poor performers. Some of these officials noted that (1) prior performance is commonly considered to some extent in making these decisions, usually as part of other evaluation factors, such as management, cost realism, or technical performance and (2) recently, prior performance itself has been explicitly used as a major

evaluation factor in some awards. Some also pointed out that if prior performance is overemphasized or used inappropriately in source selection decisions, there is a risk of legal challenges by contractors who disagree with the Government's assessment of their degree of responsibility for problems on previous contracts. In addition, they said that as currently used, consideration of prior performance is more prospective than retrospective. That is, (1) it considers the contractor's past or currently existing problems only in terms of its capability to do the work on the contract being awarded, in contrast to the approach Admiral Rickover suggested, and (2) it takes into account the contractor's proposed actions to resolve problem areas.

Admiral Rickover's notion of using Government contract award decisions as leverage to get contractors to correct problems on other ongoing work under previously awarded contracts received mixed reactions from those DOD officials we questioned on this matter. Most disagreed with this approach, at least officially, because each contract is legally separate. One high Navy official said that this approach "sounded like blackmail" and that the circumstances involved in each specific case would have to be considered and good judgment used to avoid abuse. A high Naval Sea Systems Command official stated that he might use this approach if necessary, but he probably would not admit to it. However, a program manager agreed with the approach and stated that it is used in contract negotiations, although sometimes when this approach is attempted, political pressure results in award of the contract anyway. He added that the Navy used this approach when it held up a Trident contract award until certain other problems of the contractor were resolved.

The results of others' research have shown sharp distinctions between the Government and the private sector in the use of information on prior performance. Because of the presence of specific legal constraints in the Government contract award process, such as the requirements for determining contractor "responsibility" (that is, capability to satisfactorily perform the work), use of prior performance has been found to be less efficient and effective in the Government than in the private sector.

The recent "Carlucci Initiatives" to improve DOD management included one to improve the source selection process. The primary means to accomplish this is placing added emphasis on prior contractor performance in evaluating contractor proposals during the source selection process. The rationale underlying this initiative is that (1) some cost overruns and schedule slippages result from picking the wrong contractor and (2) this is mainly due to over-emphasis on selecting sources based on cost at the expense of other factors, particularly the contractor's performance on other relevant contracts.

The Chairman of DOD's working group on this initiative stated that there is a need for greater emphasis on prior performance in source selection decisions because in some cases contractors continue to obtain Government contracts in spite of their poor performance on recent and relevant prior work. He suggested that prior performance should receive greater emphasis through its increased use in assessing other evaluation factors, such as technical and management, rather than through use of a specific "prior performance" evaluation factor. He believes this suggested approach is more sound legally. He also stated that when acquiring major systems

- more preaward effort is needed with emphasis on obtaining information directly from Government personnel most knowledgeable about the contractor's recent and relevant work, rather than from available written information; and
- purchasing office personnel, who are normally better equipped to evaluate the technical requirements of the work to be performed, should participate in the preaward survey along with contract administration personnel to provide better information for the source selection decision.

The working group is revising the DOD source selection directive for major defense systems to place added emphasis on the use of recent and relevant prior performance. The directive will encourage informal transfer of relevant data for use in source selection decisions, including more extensive use of the preaward survey. Program managers and contracting officers will be encouraged to make direct contact with their counterparts on relevant prior contracts and pursue prior performance information to whatever depth they consider necessary to arrive at a reasonable source selection judgment.

Our analysis

We found general agreement with Admiral Rickover's suggestion that the Government increase its use of contract award decisions as leverage to get contractors to correct their serious performance problems relating to proposed work. We agree with the general consensus of those we interviewed that placing more emphasis on consideration of contractors' relevant prior performance during the contract award process is the proper means to accomplish this. DOD's current efforts to improve the source selection process, as part of the "Carlucci Initiatives," have focused primarily on how increased emphasis should be given to prior performance. It is too early to know the results of these current DOD efforts. Followup will be needed to determine whether they have been effective.

Using the leverage provided by contract award decisions to get contractors to correct ongoing contract problems, as Admiral Rickover further suggested, is a more controversial idea. This is

especially true if such problems are not relevant to the work on the contract being awarded. The reasonableness of using this approach would have to be judged in each case on its individual circumstances. However, it should be recognized that the legal constraints which the Government has imposed on itself to ensure fairness in the contract award process, such as the process for determining contractor responsibility, make it difficult in some cases to use what might seem like a common sense approach in the private sector.

Matters for congressional consideration

The Committee should require the Secretary of Defense to report to the appropriate congressional committees on the specific DOD changes which occur as a result of the recent efforts to increase use of prior performance in awarding contracts. The report should assess the effectiveness of those changes. This information should be helpful to the Committee in determining whether any additional actions are needed.

DOD comments and our evaluation

DOD agrees that it can report on the changes that have occurred as a result of the efforts to increase the use of prior performance in awarding contracts.

CHAPTER 4

RESOLUTION OF CONTRACTUAL CONFLICTS

Admiral Rickover's recommendations for resolving contractual conflicts are bound together by the belief that the Navy should be willing and able to enforce its contracts. He stated that the Navy needs effective methods of dealing with a company that refuses to honor its contracts and threatens work stoppage or lengthy litigation on important military contracts to further its financial interests. He added that because of its past unwillingness to enforce contracts, the Navy encourages more litigation and work stoppage threats in the future.

To combat these problems, Admiral Rickover has made several recommendations. First, he believes that the Congress should pass legislation limiting to 1 year the time to submit fully documented claims. Contractors could not then delay claims submissions until after assessing their financial position at contract completion. Second, to deter work stoppages, he recommended that DOD be required to stop payments on all contracts with any corporation if any unit of that corporation stops work on a defense contract.

Finally, Admiral Rickover recommended that the Justice Department vigorously enforce laws against false claims. He stated that the Justice Department has demonstrated an inability to deal with false claims and a lack of commitment to applying the necessary resources to these cases.

LIMITING THE PERIOD FOR SUBMITTING CLAIMS TO ONE YEAR

Admiral Rickover stated that the lack of a time limit on the submission of fully documented claims allows contractors to wait several years to determine whether or not a particular contract was profitable and, if not, go back and establish items which they could claim were changes that added work or delayed completion. These items are then submitted together in a very large claim, sometimes years after the alleged events occurred. The Admiral stated that because construction of a single ship takes years and because claims can be submitted at any time, knowledgeable Navy personnel have often been rotated when such issues are finally raised. Because of this, he added, shipbuilders have an incentive to delay submitting claims because a delay enables them to "wait out" personnel turnover, obfuscate issues, and frustrate Government analysis of the claim. Of the claims submitted during the 1970s, Admiral Rickover said:

" * * * although the details of these claims varied, they were all large--many in excess of \$100 million per contract. They were so-called omnibus claims in which the contractor alleged, years after the fact, that the Navy required large amounts of work over and above the contract requirements,

and, therefore, owed the contractor price adjustments to cover all his overruns plus his desired profit."

Admiral Rickover said that some of these claims were so exaggerated that the Navy referred them to the Department of Justice to investigate for possible fraud.

When many items are submitted together as one large claim, the mass alone makes evaluation by the Navy very difficult. For example, outstanding claims from Litton, Electric Boat, and Newport News totaled some \$2.7 billion in the 1970s. Of this amount, Newport News' claims alone totaled nearly \$900 million and combined with documentation filled 64 bound volumes, each measuring some 2-1/2 inches thick.

The Admiral went on to say that

- because of the size and complexity of these omnibus claims, private claims lawyers and their clients know they can easily tie up the Navy in court for a decade or more,
- in addition to the great Government expense this involves, researching and evaluating these claims keep Navy personnel from performing their regular duties; and
- moreover, as time passes, Government officials come and go, memories fade, and witnesses are harder to find. The pressure on Government officials to reach a compromise settlement grows.

The Admiral stated that in an environment of threatened or actual work stoppage, poor relations with contractors, and pressure to pay the claims and move on with other Navy business, the Navy cannot hope to settle claims on merit. All of these factors, he said, work to the advantage of the shipbuilder with the inflated claim. Further, the Admiral stated that the Navy encourages the claims phenomena when it settles claims for more than they are worth just to end disputes. Admiral Rickover suggests that it often pays a contractor to submit a claim even if there is no case because the contractor will probably obtain a settlement to more than cover its expenses.

Admiral Rickover's recommended solution

Admiral Rickover recommends that the Congress establish a 1-year statute of limitations on the submission of fully documented claims. He further recommends that the payment of public funds for claims not fully documented and submitted within this period be prohibited by law.

DOD's position

DOD initially concurred with one year and recommended that it begin at the time the act (or failure to act) occurred on which the contractor bases a claim.

In commenting on our draft report, DOD changed its position. While the Department still agrees that some time limit is necessary, it is not convinced that all legitimate claims can be recognized within 1 year.

Findings

Most Navy officials we interviewed agreed that some time limit on claims submission was necessary. 1/ While their estimates of a reasonable time generally ranged from 1 to 2 years, many agreed with the 1 year recommended by the Admiral. In a separate review, the Investigative Staff of the House Committee on Appropriations found that without such a time limit, the Navy never knows when a claim may be submitted and remains "on the hook" until a shipbuilder chooses to sign a release to close out a contract. Shipbuilding officials and industry lawyers we spoke with, however, are against any time limit but said that if one were to be imposed, it should be at least 5 or 6 years.

A legal expert who represents a number of shipbuilders said the 1-year time limit would put a disproportionate burden on contractors because they often cannot identify every constructive change 2/ that has increased costs within that time, much less fully document each claim. He noted that this new burden would hurt the Government in the long run by forcing the contractor to be too claims conscious. Because of this, energy spent protecting the claims posture may be diverted from production and performance. In addition, he said such a limitation would result in the "protective filing" of many claims.

If a time limit is to be imposed, the industry representative recommends that it be much longer than one year. He noted that most State statutes of limitations for breach of contract

1/Presently, shipbuilders have until contract close-out to submit claims. This does not generally occur until several years after all ships are delivered.

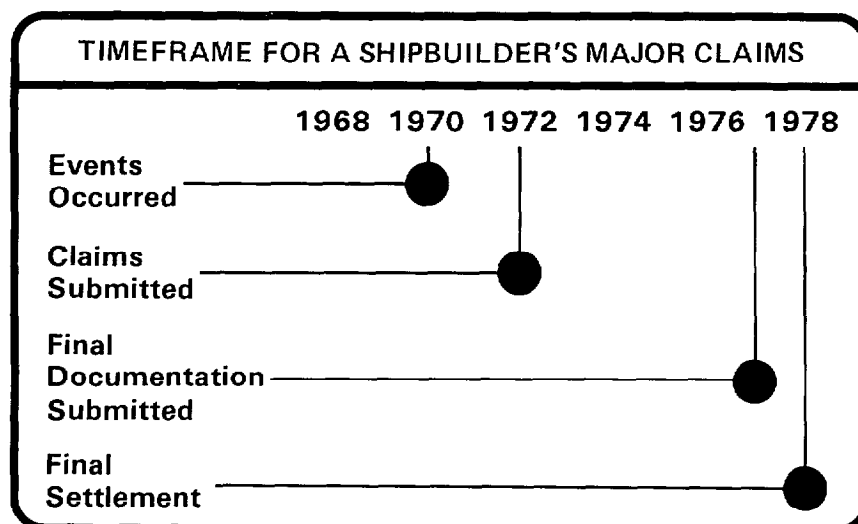
2/A constructive change results from Navy action or inaction that causes the contractor to do work which is different from or in addition to the contract terms. Constructive changes are initially identified by the contractor and presented to the Government as a request for additional compensation. If Government officials agree that a change has occurred and accept responsibility for the change, it becomes a formal change after it is approved in writing. If they disagree that the Government caused the change or disagree on the dollar impact of the change, it may result in a contractor's claim against the Government for reimbursement of costs incurred or delay in delivery. (For a discussion on types of contract changes in shipbuilding programs, see our report entitled "Better Navy Management of Shipbuilding Contracts Could Save Millions of Dollars" (PSAD-80-18 Jan. 10, 1980)).

are 6 years and that a less recognizable constructive change deserves at least as much consideration. He further suggested that any limitations rule require only claim filing and not full documentation as Admiral Rickover proposed. Finally, he suggested that any new limitations period be negotiated as an optional clause on a contract-by-contract basis.

The Navy has recently begun to use a "Notification of Changes" clause on some shipbuilding contracts. Its purpose is to induce prompt reporting of any action which the contractor believes would constitute or require a change to the contract. The clause requires the contractor to notify the Navy of such action within 30 days after the event. Further, the contractor must sign releases at 6-month intervals covering the previous 9 to 15 months for all actions not specifically reported in this manner. Thus, the contractor must identify promptly any possible claims or lose rights to future entitlement.

In some cases, shipbuilders have refused to accept such a clause, arguing that acceptance would result in waiving their rights to recover proper costs. Electric Boat, for example, insisted on and obtained a provision allowing it to submit claims under one contract at any time by alleging that an act under another contract gave rise to the claim--the "cross contract impact theory." While it has met with significant contractor resistance, the notification clause has been included in some submarine contracts. Although its effectiveness is still unproven, most officials believe the clause will help to some degree. The notification of changes clause, however, is not required by law and may continue to be rejected by contractors in the future. Also, since this clause only requires that the Navy be notified, submission of fully documented claims may still be deferred for years. Figure 4-1 shows how lengthy the claims process was on major claims by a shipbuilder during the 1970s. In addition, it shows that the 6-year limit, which one private legal expert suggested, approximates the status quo.

FIGURE 4-1



Admiral Rickover believes it is inconceivable that a responsible shipbuilder could still be unaware of a problem serious enough to lead to a claim within the time period allowed under the present notification clause. However, private attorneys we talked with pointed out that there is a difference between being aware of a problem and being able to fully document it. In some cases, they stated, the cost of delay and disruption cannot be determined precisely even when the contract is complete.

Navy officials note that there needs to be an understanding of the event from which the time limit would be measured. For example, if the contractor followed incorrect Navy drawings or specifications, would the event be the original design error or the act to correct it? According to knowledgeable Navy officials, it is from the time that additional work is found necessary due to the corrected drawing that the proposed 1 year should begin. Similarly, defective Government-furnished equipment could give rise to claims involving extra installation costs as well as delay and disruption. The 1-year time limit would start running not from original receipt of defective Government-furnished equipment but rather from the time the Government orders its repair or replacement.

One shipbuilder said the current Notification of Changes clause is sufficient in that it eliminates any surprise claims against the Government. In addition, a mandatory time limit on full documentation would be almost impossible to comply with. This contractor expressed concern over the meaning of "fully documented" and how it might be interpreted in particular cases. Overall, the contractor objected strongly to a 1-year limit and said that legislation was not needed for the Government to get documented claims as soon as the contractor is able to do so.

Our analysis

The delay allowed for claims submission has undoubtedly been a major factor in the inability to settle claims and enactment of a time limit should help. As discussed in the next section the Contract Disputes Act of 1978 allows contractors to settle disputes more quickly than in the past, but a statute of limitations is also needed to restrict claims submissions to recent events.

Some experts in the field say that additional claims might be filed if there were a statute of limitations. However, the risks of such "protective filing" must be weighed against the benefits of keeping claims submissions current. Clearly, a time limit to be negotiated on a contract-by-contract basis is not workable in light of past experience. Contractors have insisted on loopholes in accepting such clauses and in some cases have refused to accept them outright.

Aside from obscuring the relevant issues, long delays in claims submissions often result in later delays in claims settlement. The inability to settle claims for long periods of time sometimes years, has led to such things as contractor financial

problems, threatened and actual work stoppage, and hostile relations between Government and contractor. The situation deteriorated so greatly during the 1970s that all three major shipbuilders threatened to stop work on Navy contracts entirely and one actually did so (see next section).

It is clear that the choice of any particular time limit over another would be arbitrary and we are in no position to substitute our judgment for Admiral Rickover's. The shorter the time limit, however, the greater the probability of numerous "protective filings" by contractors. This risk could be reduced by an increased time limit, but if it is too lengthy, there would be no assurance of timely claims submissions. Therefore, we believe the Committee should explore an appropriate time limit during hearings, get additional views, and determine whether the proposed 1-year limit equitably balances the risks on both sides.

Along with the time limit, there needs to be guidance and agreement on what constitutes acceptable and satisfactory documentation for claims. Contractors should know what type of documentation is required before they are involved in a claims situation.

Matters for congressional consideration

The Committee should obtain additional views on the appropriate time period and propose legislation which would

- prohibit payment of public funds for claims not submitted, documented, and certified within a specified time, and
- require contractors to notify the Government promptly of actions or inactions which they feel constitute a change to the contract as well as provide a release from claims at prescribed intervals.

Industry comments and our evaluation

In its comments on our draft report Newport News said one year was much too short and added that a notification of changes clause is already used in some contracts. The company opposed any time limit and stated that there are impacts across contracts which cannot be determined for many years. Further, the contractor asserts that there are instances where it is simply unable to determine the extent of costs and damages resulting from contract changes.

In addition, Newport News stated that inadequate Government-furnished equipment frequently caused claims and that such inadequacies might not be known until several years after delivery.

The notification clause referred to by Newport News in its comments provides merely for notification and not for submission

of documented claims. Further, this clause has not been universally accepted by contractors. Therefore, we believe statutory coverage and a time limit is needed to keep claims submissions current.

With respect to Newport News' comment on the impacts of changes across contracts, the Navy does not normally accept this theory.

As noted earlier in this section, the time period could not begin running before the contractor received the order to repair or replace the defective Government-furnished equipment discussed in Newport News' comments. In other words original delivery of the equipment in such a case would not, as Newport News implies, be the triggering event.

DETECTING WORK STOPPAGES

Although required contract language states that contractors shall continue performing in the event of a dispute, all three major shipbuilders threatened to stop work during the 1970s and one actually did so. Admiral Rickover stated that shipbuilders threaten work stoppage to gain leverage in contract disputes against the Navy. In instances of threatened or actual work stoppages he said that the Navy has had to obtain a court order or agree to special financing arrangements to ensure continued contractor performance.

Admiral Rickover sees no reason why the Government should allow such stoppage on a program vital to national security. He stated that when the contractor can hold a ship hostage, the Navy cannot hope to settle disputes on their merits. The Admiral added that unless the Congress acts to prohibit payments on all contracts with a corporation that stops work on a vital defense program, contractors will continue to assert the right of work stoppage to exact favorable settlements or obtain lucrative interim financing arrangements.

He also noted that the practice of paying a contractor money in dispute pending the outcome of a case (1) eliminates any contractor incentive to hasten resolution and (2) encourages shipbuilders and their lawyers to delay adjudicating relatively simple disputes almost indefinitely.

Admiral Rickover's recommended solution

Admiral Rickover recommends that DOD be required to stop payments on all contracts with any corporation during the period in which any division of that corporation does not proceed in good faith to perform on any defense contract or subcontract. Such corporation should also be required to obtain a performance bond at its own expense covering its contracts for the succeeding 10 years. Finally he said that the Congress should prohibit DOD

from financing contractors beyond the amount DOD determines they are owed. 1/

DOD's position

DOD said that stopping payments corporate-wide ignores the concept of a single contract and the complexity of present day corporate structures. Corporations may have affiliates and divisions, each conceivably having many contracts with different departments of Government. Stopping payments corporate-wide because one corporate division stops work on a single contract would result in a multitude of conflicting interests among various governmental customers. According to DOD, the suggested approach is neither legally sound nor practical.

DOD further stated that it is already Department policy that provisional increases in contract price should not exceed the amount owed based on the Government's estimate. 2/

Findings

The Contract Disputes Act of 1978 was passed to provide for the timely resolution of contract claims and disputes. Several provisions of the act allow contractors to settle disputes more quickly than in the past. Under the act, the contracting officer must issue a decision or give a date when a decision on a claim will be issued. If there is undue delay, the Armed Services Board of Contract Appeals can order a decision to be issued and if the order is not met, the contractor can treat the lack of a decision as a denial of the claim. The act allows the contractor at this point to go directly to the U.S. Claims Court.

The current DOD disputes clause states that " * * * the Contractor shall proceed diligently with performance of the contract pending final resolution of any request for relief, claim, appeal, or action arising under or related to the contract* * *." However, if the contract is breached by the Government, it is uncertain whether in all cases, the contractor can be required to continue work. Claims of invalid or breached contracts have been the basis of all three major shipbuilders actual or threatened work stoppages.

The most serious incident involving work stoppage occurred in the summer of 1975. Newport News stopped work on a Guided

1/ Admiral Rickover was concerned about court ordered financing.

2/ Here, DOD missed the Admiral's point. DOD policy is not the issue. Unless the Congress prohibits such payments, courts may continue to direct departmental payments in excess of the amount DOD determines it owes.

Missile Cruiser alleging that its contract was not valid. Although Newport News never filed a claim under the cruiser contract, the action was taken partly to emphasize its cash flow problems made worse by the outstanding claims against the Navy. (These claims reached \$894 million by March of 1976.) Construction on the cruiser was resumed by a court sanctioned agreement which required the Navy to pay the cost of the ship's construction plus 7 percent. Ordinarily, agencies are prohibited from using such a "cost plus" type contract.

Figure 4-2 depicts the circumstances surrounding the two threatened work stoppages and the interim agreements reached.

FIGURE 4-2

Threatened Work Stoppages

	<u>Claims</u> ---(millions)---	<u>Proposed Navy settlement</u>	<u>Work stoppage threatened</u>	<u>Reason</u>	<u>Interim settlement</u>
Litton/ Ingalls	\$505	\$239	6/76	Cash flow problems; alleged con- tract breach	91% of cost
Electric Boat	544	125	3/78	Cash flow problems; alleged con- tract breach	100% of cost

In effect, all three shipbuilders claimed that no contracts were in force at the time they threatened to stop work. For example, in one of the two instances of threatened work stoppage, Electric Boat broke off negotiations with the Navy on two contracts, contending that it was incurring over \$16 million per month in unreimbursed costs as a result of material breaches by the Government. Electric Boat claimed these breaches were caused by the Navy's (1) failing to make timely and adequate payments; (2) providing late, incomplete, or otherwise unsuitable drawings; (3) imposing extraordinary delays; and (4) otherwise frustrating the company's ability to perform efficiently under the contracts.

In cases of work stoppage where sufficient contractor competition exists, it is DOD policy to terminate the contract and purchase the goods or services elsewhere. DOD officials pointed out, however, that such a policy is not workable in sole-source situations. Moreover, a Navy official said that even with multiple sources, it would be impractical if not impossible to move a partially completed ship from one shipyard to another to finish the work.

Several Navy and DOD officials have noted that shipbuilders threats of work stoppage are too rare to require a legislative remedy. In addition, they as well as private sector experts, said the decision to stop work is not made lightly and is the last resort of a contractor incurring losses. Another DOD official acknowledged that shipbuilders do not want to stop work and that threats of work stoppage are rare. He pointed out, however, that a work stoppage causing a schedule delay could have grave consequences for DOD. For this reason, he stated that the Government should have the tools to deal with such a situation.

Most DOD and Navy officials, a shipbuilder, and private experts we interviewed said that the courts provide an acceptable remedy to keep contractors working, but one high Navy official said that this approach is not always desirable. Admiral Rickover also finds the courts' action unacceptable because the Navy was ordered to finance work until disputes were resolved removing the contractor's incentive to settle. A concern that interviewees expressed quite often, in fact, was how to keep a contractor working if it could not afford to do so. Some also questioned whether or not the Government had the right to force contractors to continue working.

The consensus among interviewees was that regardless of the penalties for noncompliance, a contractor would not likely obey an order requiring continued performance while incurring huge losses. Two consultants, an expert in the field and a shipbuilders' lawyer, have suggested that on future contracts, arrangements be made for the Navy to finance work in such situations. Then, if the dispute is settled for less than this amount, a contractor would be required to repay the difference with interest.

As noted earlier, in addition to stopping payments corporate-wide in cases of work stoppage, the Admiral wanted any contractor involved in such an action to obtain at its own expense a performance bond covering future contracts. One shipbuilder who looked into performance bonds said (1) it could not obtain enough coverage for large ships (a carrier, for example, costs \$3 billion) and (2) the cost of such a bond would be prohibitive (10 percent of the bond's value). In addition, most officials said that regardless of how such legislation were worded, the Government would ultimately incur the cost of such a bond. For example, the sole-source shipbuilder mentioned above said it would simply add the bonding fee to the profit negotiated on the contract.

Our analysis

We cannot endorse legislation requiring DOD to stop payment corporate-wide. Such drastic measures would only serve to compound the problem, rather than solve it. For example, stopping payment could force a contractor's parent corporation to institute a work stoppage on other vital defense contracts. These additional work stoppages might well have sound legal justification (based on non-payment) and could lead to huge claims for

delay and disruption. If such a sequence of events evolved, the best interest of the Government would not be served. In addition, we believe that because of the severe consequences to national defense, DOD would not actually take such action. Therefore, even the threat of such action would likely be useless as a deterrent.

The changes brought about by the Contract Disputes Act of 1978 together with the adoption of limits on the time period for claims submissions should encourage more timely resolution of disputes. This in turn should keep the claims process more current and help reduce both the amounts in dispute and contractors' cash flow problems.

Notwithstanding such improvements, a claim of contract breach may still be the basis for stopping work on critical national security programs. We believe that the Congress and DOD should consider a policy to deal with work stoppages in cases where termination and reprocurment is not practical or feasible. Policy deliberations should address:

- Whether work stoppages adversely affecting critical national security programs should be tolerated for any reason, and if not, what penalties should be imposed.
- Whether a special policy is needed on Government interim financing in situations where contractors cannot afford to continue work.

Matters for congressional consideration

The Committee should require the Secretary of Defense to develop a policy addressing work stoppage and related Government financing in situations where the present policy of termination and reprocurement is not feasible, and submit legislation if necessary.

DOD and industry comments and our evaluation

DOD does not agree that a new policy is needed. The Department states that the disputes clause requires contractors to continue performance during disputes, even those involving an alleged breached contract. We recognize that since the work stoppage threats of the 1970s the disputes clause has been broadened to include disputes related to as well as under the contract. However, knowledgeable DOD officials and outside experts disagree concerning whether or not the parties are bound to a contract that has been breached. Therefore, to eliminate any question, we believe a policy is needed to keep contractors working on critical defense projects.

In the past, contractors have been kept on the job through agreements or court orders having little to do with the merits

of the case. Because the Navy was not willing to wait out a lengthy work stoppage, these cases were never resolved in court. We believe serious disputes should be resolved on their merits with freedom from such work stoppage threats. In order for a work stoppage policy to be practical, it must also provide some level of financing to keep contractors working until a court determination can be made on the validity of the contract in question.

Newport News does not believe that Congress could develop such a policy but does not say why.

ENFORCING FRAUDULENT CLAIMS STATUTES

Federal laws make it a crime to submit false claims against the Government. 1/ Admiral Rickover states that the Justice Department (1) is not able to cope with false claims prepared by sophisticated claims lawyers and (2) lacks the commitment to apply the necessary resources to cases referred by the Navy. He has complained directly to the Attorney General that " * * * it appears that the Justice Department is systematically closing down these investigations either overtly or by inaction * * *."

Admiral Rickover stated that the Justice Department is overloaded with work and there is a strong tendency to drop difficult cases when no "smoking gun" is present which would assure a high degree of success in court. He said sophisticated claims lawyers rarely leave incriminating evidence such as a forged or altered document. The Admiral is concerned that Justice may be passing up cases of greater importance to society for ones easy to win.

Figure 4-3 shows Admiral Rickover's complaints and charges concerning major shipbuilding cases the Navy referred to Justice.

1/ See 18 U.S.C. 286-287.

FIGURE 4-3
Cases Referred to Justice

<u>Contractor</u>	<u>Date referred</u>	<u>Status/ disposition</u>	<u>Admiral Rickover's specific complaint</u>
Lockheed	1974	No indictment sought	Inability or unwillingness to prosecute sends the wrong signals to Government contractors
Litton	1974	Indicted 1977	No action
Electric Boat/ General Dynamics	1978	Dropped; insufficient evidence	Inability or unwillingness to prosecute sends the wrong signal to Government contractors
Newport News	1978	Still open	Abolished unit working on case; reassigned team members

Admiral Rickover believes many DOD officials have the attitude that unfounded and exaggerated claims are not unusual and constitute no criminal conduct. As long as contractors can make out financially by submitting grossly inflated claims as the basis for lump sum settlement negotiations, Admiral Rickover contends, the Navy will be plagued with inflated and unwarranted claims. The Admiral believes the Navy must protect itself because these claims burden the naval establishment, divert technical people from their primary tasks, and can result in settlements higher than the claims are worth.

Admiral Rickover's recommended solution

Because such claims waste time and money and threaten the integrity of Government contracts, the Admiral recommends that the Justice Department vigorously enforce criminal laws against false claims.

DOD's position

DOD agrees that the criminal fraud statutes should be vigorously enforced by the Justice Department. DOD added that in several ship claims cases, Navy personnel and resources have been made available to Justice attorneys to assist in investigating alleged false claims. In addition, DOD maintains liaison with the U.S. attorneys and the Department of Justice in an effort to facilitate prosecution.

DOD also pointed out that in ship claims cases, the Department of Justice encountered problems with the Navy claims process which made criminal prosecution difficult. While portions of these claims were found to be overstated, requisite criminal intent was hard to pinpoint. Moreover, DOD said the head of Justice's Criminal Division has expressed a desire to bring together experienced claims personnel from different agencies to (1) improve the claims process and (2) provide additional investigative support to enhance prosecution. An informal committee has been formed of representatives of the Criminal Division's Fraud Section, the military services, and the Office of the Secretary of Defense. This group meets to consider mutual enforcement concerns and open the lines of communication at the working level.

Findings

DOD personnel hold differing views as to what constitutes fraud. A Navy program manager told us that he does not believe fraud existed to the extent charged, but perhaps in only a few isolated instances. He suggested that the practice of contractors asking for more, so they get what they need, is similar to contract negotiations.

The Contract Disputes Act of 1978 addresses this problem by requiring that:

"For claims of more than \$50,000, the contractor shall certify that the claim is made in good faith, that the supporting data are accurate and complete to the best of his knowledge and belief, and that the amount requested accurately reflects the contract adjustment for which the contractor believes the government is liable."

The Senate's Judiciary and Governmental Affairs Committees' report (No. 95-1118) accompanying the act states that the above provision is:

" * * * included out of concern that the submission of baseless claims contributes to the so-called horsetrading theory where an amount beyond that which can be legitimately claimed is submitted merely as a negotiating tactic."

Payment of such a claim, of course, would be a windfall to the contractor. It was the Committees' view and the law's intent that this practice be eliminated so that disputes involve only true amounts.

Some Navy and DOD officials have stated that certification is useful; others have stated opinions to the contrary. One official said that the requirement might induce a contractor to take steps he would not otherwise take. Another Navy official agreed and added that although an individual signs the certification, no

one person could be certain that everything in a claim is entirely true and correct and, therefore, no one person could really be held accountable. In any event, some of these officials agreed that it will take time to measure the effectiveness of certification.

A Justice Department official we interviewed believes that the certification requirement (1) is good because it makes the contractor think twice but (2) is not very useful for prosecution because the certifying official is usually far enough removed from the operations to claim ignorance of the true situation.

The Justice Department official also told us that it is difficult to establish fraud in ship claims cases because both the Navy and the contractors have given credence to the process of negotiating inflated claims. A knowledgeable former Navy official told us the Board of Contract Appeals encouraged large claims by splitting the difference with contractors. In addition, the length of time that has elapsed with these cases has made it difficult to determine who did what and whether it was done with criminal intent. Because it is difficult to prove criminal fraud, a former Navy official suggested that the Government concentrate on proving that claims are merely false, which is a civil matter and is much easier to prove.

Another problem in proving fraud, according to a Justice Department official with whom we spoke, is loose Navy claims standards. He believes the Navy and other Government agencies need to improve them. On this point the former Chairman of the Navy Claims Settlement Board noted the lack of documentation and support provided in shipbuilding claims. He has advocated the establishment of standards for claim submissions and Admiral Rickover has agreed.

In our discussions with the former Chairman, he elaborated further on the need for claims standards. He said claims go on and on with page after page of legal and technical reasoning. It is sometimes difficult, he notes, even to determine what a contractor is claiming. He suggests that the Navy and its contractors should agree on what constitutes acceptable evidence for certain types of claims. While claims dealing with numbers of parts or physical entities are easy to evaluate and prove, those dealing with delay and disruption are far more difficult to evaluate and clear proof is nonexistent. For this reason, acceptable forms of evidence must be agreed upon at the outset of a contract. Further, because the Navy must do a legal and technical evaluation of a claim, it should be submitted in a standardized format. He suggests that the legal and technical arguments be made separately. Finally, he would have the claimant draw conclusions from the many arguments and state specifically what is being claimed and why.

The former Chairman said that if the contractor is submitting a claim based on delay and disruption, it should be incumbent upon the contractor to pinpoint the items causing the delay. He would also require cost breakdowns for these items rather than allowing claims to include only lump sum requests.

The Office of Policy and Management, Department of Justice, is conducting a study on developing a better fraudulent claims program. Justice expects this study to be useful in identifying problems and developing approaches to correct them.

According to a Justice official, a new Justice Department unit will conduct investigations and prosecute nationally significant DOD procurement fraud and corruption cases. This procurement fraud unit will also handle future false shipbuilding claims. The cases now under investigation, however, will continue to be handled by Justice personnel to whom they were originally assigned. The official also stated that the Litton and Newport News cases are still open and being pursued diligently.

Our analysis

Certification as required under the Contract Disputes Act of 1978 should give pause to exaggerated claims. This plus adoption of requirements for timely claims submissions (see the Admiral's earlier recommendation) should make it easier for the Justice Department to deal with any suspicious claims.

Some contend that a top company official certifying a claim can later allege ignorance of the details. However, we believe that the certifier can be held responsible and should at the very least be quite familiar with the grounds for the claim, and the reasonableness of the techniques used for determining the cost and arriving at the amount claimed.

The study by the Justice Department's Office of Policy and Management could be helpful if it results in better guidelines for handling future claims and for use in prosecution where fraud is suspected. Establishment of the special investigative unit within the Justice Department could also lead to more vigorous prosecution of false claims.

Pending cases should be resolved as soon as possible. If the Department of Justice has enough evidence, it should institute the appropriate litigation. If not, the Department should either obtain the evidence required for prosecution or close these cases for lack of evidence.

Matters for congressional consideration

DOD should be required to establish, in consultation with the Department of Justice, claims handling procedures and standards for the future that discourage false claims, make evaluation easier, and facilitate prosecution where fraud is suspected.

Admiral Rickover, Justice and
industry comments

In commenting on our draft report, Admiral Rickover said we missed the point in our discussion of fraudulent claims statutes. He strongly advocated prosecution and concluded that the Justice Department mishandled its investigation of ship-builders' claims against the Navy. In addition, he sees a need for a thorough investigation of the handling of these cases. He said that each time the Department decides not to prosecute obviously false claims, it encourages others to make exorbitant claims against the Government. The Admiral went on to raise questions that he felt we should take up with Justice. The Admiral asks the following questions. (The full text of his comments can be found in app. IV.)

--Why were the Lockheed and Electric Boat cases dropped?

--What has caused the delay in the Litton case?

--What has caused the delay in the Newport News case and will there be a statute of limitations problem?

--Are there problems in applying the statutes and are changes needed?

Since we received Admiral Rickover's comments, the Justice Department has provided us with its position on the dropped cases. The Department says it declined the Lockheed and Electric Boat cases because thorough investigations revealed insufficient evidence of criminal fraud. Justice says these conclusions were reached only after extensive investigations and were based exclusively upon the merits of the evidence developed by the Navy before referral, by lengthy grand jury proceedings and by comprehensive FBI investigations coordinated with Justice lawyers.

In the case of Electric Boat, for example, a Justice official said the case was declined for four reasons: (1) the investigation could not link portions of the claim that may have been incorrect with the requisite criminal intent; (2) although the claim was based on certain theories that overstated the amount, Electric Boat disclosed its theory and limited underlying facts to the Navy which was appropriately skeptical; (3) the Public Law 85-804 settlement with the contractor made fraud a difficult theory of prosecution; (4) disapproving a number of technical items could not alone support a case without more direct evidence of fraudulent intent.

For its part, Electric Boat stated that its claim against the Navy was a normal commercial dispute and should have been so treated.

With respect to the delay in the Newport News and Litton cases, Justice officials refused to discuss the cases generally as they are still pending. One official did say, however, that the Department is conscious of the statute of limitations referred to by Admiral Rickover but does not see it as a problem.

The court has just recently dismissed the Litton case. However, the Justice Criminal Division official still refuses to discuss it because the judge has not given his reasons for the dismissal. The official further stated that the Department may appeal the dismissal.

According to this official, there are problems in prosecuting these claims cases but the problems are not with the statutes. Rather, he said, the problems are with the evidence and with the way claims are processed in the Navy.

CHAPTER 5

OVERVIEW - EXTERNAL COMMENTS AND OUR EVALUATION

We obtained comments on a draft of this report from Admiral Rickover, the Departments of Defense and Justice and the two private shipbuilders presently involved in construction of nuclear ships. Where significant differences exist between the GAO report and the commentors on the treatment of individual procurement issues, a discussion is included in the particular chapter dealing with the issue. This chapter presents an overview of the general tenor and our evaluation of the comments received.

ADMIRAL RICKOVER

Admiral Rickover agreed with the report presentation on all but one of the issues (see enforcing fraud statutes) but characterized actions for congressional consideration as "too vague and weak to generate corrective action." He urged that we make them explicit, citing two examples where we had done so. In some cases these actions have been strengthened and made more specific. In other cases either (1) the Admiral's comments did not recognize specific actions that were contained in the report or (2) we do not have a basis for urging the particular action that he wants taken. His specific concerns and our evaluations are in appendix IV.

DEFENSE DEPARTMENT

DOD believes the report represents a well-balanced treatment of a series of recommendations that are quite controversial, even among procurement experts. DOD agrees with our assessment of the matters for congressional consideration except in several instances which have been discussed in the report. DOD believes substantial progress is already being made in improving the procurement process. (See app. VII.)

JUSTICE DEPARTMENT

The Justice Department wanted to clarify two points: (1) the reasons for declining to prosecute the two closed cases (these reasons have been added to the report), and (2) what Justice feels are misconceptions over its role in establishing guidelines and standards for future cases of this kind. (See app. V.)

INDUSTRY

Electric Boat officials met with us and said they preferred the two-way exchange of ideas as opposed to making written comments that might open old wounds between the company and the Navy. Electric Boat officials were constructive in their comments which dealt mostly with the hasty buildup and work stoppage issues.

Their comments have been incorporated in the appropriate sections of the report.

Electric Boat's overall concern with the report was the inclusion of unverified assertions by Admiral Rickover. We have decided to retain them because (1) it is important that the reader know the reasons for the Admiral's recommendations, (2) there is a consensus on the validity of the underlying problems themselves, and (3) we received feedback from others that the report is balanced overall.

Newport News said that overall we have done about the best job possible in summarizing Admiral Rickover's statements and DOD responses, and in specifying actions for congressional consideration on each issue. It did question, however, actions on several of the issues and these questions are discussed in the appropriate section of the report. (See app. VI.)

APPENDIX I

MAJORITY MEMBERS

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JULIAN C. DIXON, CALIF.
VIC FAZIO, CALIF.
W. G. (BILL) HEFNER, N.C.
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WILLIAM H. GRAY III, PA.
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Congress of the United States

House of Representatives

Committee on Appropriations

Washington, D.C. 20515

March 12, 1982

APPENDIX I

MINORITY MEMBERS

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CLERK AND STAFF DIRECTOR
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TELEPHONE:
(202) 225-2771

The Honorable Charles A. Bowsher
Comptroller General of the United States
General Accounting Office
Washington, D. C. 20548

Dear Mr. Bowsher:

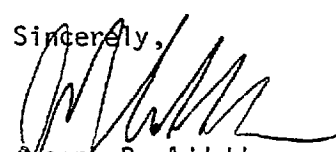
The distinguished Admiral Hyman G. Rickover, the former Director of the Naval Nuclear Propulsion Program testified before the Joint Economic Committee on January 28, 1982. As part of his testimony, Admiral Rickover provided a series of recommendations for specific improvements in the organization of the Defense Department, military personnel policies, and in procurement.

During the past several years, your office has also provided the Congress and this Committee with recommendations for improving Department of Defense operations.

After closely reviewing Admiral Rickover's suggestions, I am requesting, as a matter of priority, that your office undertake a review to determine whether these recommendations are both feasible and practical, and at the time span during which they can be implemented with least disruption. Also, I would hope that your efforts would provide some insight as to the potential savings relating to those specific recommendations that you agree should be implemented.

I ask that you keep the Committee informed through periodic reports and briefings during the course of this year, and issue a report prior to the fiscal year 1984 hearings with Secretary Weinberger, which will be scheduled sometime in February, 1983.

Sincerely,


Joseph P. Addabbo
Chairman
Subcommittee on Defense

WILLIAM V. ROTH, JR., DEL., CHAIRMAN	
CHARLES H. PERCY, ILL.	THOMAS F. EAGLE, MO.
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IRA S. SHAPIRO, MINORITY STAFF DIRECTOR

United States Senate

COMMITTEE ON
GOVERNMENTAL AFFAIRS
WASHINGTON, D.C. 20510

June 18, 1982

Honorable Charles A. Bowsher
Comptroller General
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Bowsher:

In January of this year, Admiral Hyman G. Rickover (retired) testified before the Joint Economic Committee concerning the "Economics of Defense Policy." During the course of his testimony, Admiral Rickover suggested a series of recommendations to improve the efficiency and management of defense programs. Many of these recommendations concern areas in which the General Accounting Office has made recommendations in the past.

I would appreciate receiving your views on Admiral Rickover's recommendations. Of particular interest to me are his recommendations number 6 and 9, 14 through 18, 19, 24, 26 through 28, 31 and 32. I have enclosed a copy of the recommendations for your review. 1/

I appreciate your consideration of this matter and if there are any questions, please have your staff call Mr. Link Hoewing of my Committee staff at 224-4751.

Sincerely,

Bill Roth
William V. Roth, Jr.
Chairman

WVR:sb

Enclosure

1/In a subsequent meeting with GAO the Committee agreed to the same scope and timing as the House request (see Appendix I).

SSN-688 CLASS SUBMARINE ACQUISITION HISTORY

The Navy was pursuing a dual sourcing acquisition strategy for the SSN-688 program by (1) bringing Newport News into the nuclear submarine construction business as the designer and lead yard and (2) splitting the award of the first contract for follow ships in early 1971 between Newport News and Electric Boat. 1/ However, the Navy appears to have negated the logic of this approach by awarding all 11 ships to Electric Boat on the second follow ship contract in late 1973. 2/

<u>Year</u>	<u>Total of ships</u>	<u>Awarded to:</u>	
		<u>Newport News</u>	<u>Electric Boat</u>
1971	1 (lead ship)	1	0
1971	11	4	7
1973	11	0	11
1975	3	3	0
1976	2	2	0
1977	3	3	0
1979	2	0	2
1981	3	3	0
1982	<u>5</u>	<u>1</u>	<u>4</u>
Total	<u>41</u>	<u>17</u>	<u>24</u>

This decision, which had long-term repercussions, left Electric Boat with contracts for construction of 18 of these ships compared to only 5 for Newport News. After the first Trident submarine was awarded to Electric Boat in July 1974, that shipyard's large backlog of work made it less competitive. Consequently, Newport News was competitively awarded contracts for the next eight ships between August 1975 and September 1977.

1/Electric Boat had been designer and primary supplier on the previous SSN-637 class program.

2/Our April 1982 report on submarine construction problems at Electric Boat (GAO/MASAD-82-29) noted that strong indications existed, as early as negotiations on this award, that Electric Boat's direct labor hours were underestimated. Electric Boat proposed to construct the SSN-688s for about the same direct labor hours as the previous SSN-637 class submarine, even though the SSN-688 displaces 2,600 more tons and is 68 feet longer. Moreover, the direct labor hour estimates were substantially below its only competitor and well below the Navy's estimate.

During that time, Electric Boat's problems began to surface and it filed claims for \$544 million in December 1976. In April 1978 Electric Boat reported a projected loss of \$843 million on its SSN-688 contracts. In June 1978, the Navy agreed to settle the \$544 million claims for \$125 million and agreed to pay Electric Boat another \$359 million, half the contractor's remaining expected loss, under Public Law 85-804.

Nevertheless, the Navy based the evaluation criteria for the next contract (the fifth follow ship contract) primarily on price. Then, the Navy was legally precluded from selecting Newport News when Electric Boat's offer was lower, although the Naval Sea Systems Command and the Naval Material Command regarded it as unrealistically low and ultimately more costly to the Government. Our April 1982 report also noted that the preaward survey for this award recommended not awarding the contract to Electric Boat because, in part, the estimates were considered overly optimistic and presented a high risk for cost growth. As indicated above, the Navy concluded that it had no reason not to make the award because Electric Boat had adequate financial resources to complete the contract. However, in effect, based on its own estimate, the Navy accepted the very high risk of 23-percent overrun at the outset of this contract.

After that, the special statutory authority for maintaining the defense industrial mobilization base was used in making the next three awards to ensure that both sources remain viable. 1/

This history raises the question as to why the Navy did not adhere to its original dual sourcing strategy by favoring split awards between the two sources. In particular, the 1973 decisions to award all 11 ships to one source seem to have put the potential short-term benefits of promised lower prices ahead of the long-term benefits of maintaining two competitive and reasonably balanced sources. The short-term benefits proved to be illusory and the imbalance created by this action set the stage for further problems in the future.

1/Our Office's April 1982 report on submarine construction problems, cited above, concluded that cost growth at Electric Boat will likely continue on each SSN-688 and Trident contract negotiated before October 1981 because (1) Electric Boat consistently understated the single largest cost element in submarine construction--direct labor, and (2) the Navy knowingly used Electric Boat's unrealistically low estimates to establish original and updated contract costs and baselines for cost growth measurement.

Listing of SSN-688 Class Submarine Contract Awards

<u>Date</u>	<u>Description</u>
December 1969	A contract to perform detail design and lead yard services for the SSN-688 class was awarded to Newport News. <u>1/</u>
January 1971	A sole-source contract for construction of the lead ship was awarded to Newport News. <u>1/</u>
January 1971	Eleven fiscal year 1970-72 follow ships were awarded competitively to Newport News (4 ships) and Electric Boat (7 ships).
October 1973	Seven fiscal year 1973-74 ships (with priced options for up to four additional fiscal year 1973-74 ships) were awarded competitively to Electric Boat.
December 1973	The option for four additional ships from Electric Boat was exercised. <u>2/</u>
August 1975	Three fiscal year 1975 ships (with priced options for one or two fiscal year 1976 ships) were awarded competitively to Newport News.
February 1976	The option for two additional ships from Newport News was exercised.
September 1977	Three fiscal year 1977 ships were awarded competitively to Newport News.
April 1979	Two fiscal year 1978-79 ships were awarded competitively to Electric Boat.

1/These contracts were awarded sole-source to establish a second source (besides Electric Boat, which had been the designer and primary supplier of the SSN-637 class submarines) for construction of SSN-688 class follow ships.

2/At this point, the Navy had awarded to Electric Boat contracts for construction of 18 SSN-688 class ships versus 5 to Newport News. In addition, the first Trident submarine was awarded to Electric Boat in July 1974.

<u>Date</u>	<u>Description</u>
August 1981	Three ships (two fiscal year 1980 and one fiscal year 1981) were directed sole-source to Newport News to maintain this supplier at a level necessary to meet the requirements of industrial mobilization in the case of a national emergency (10 U.S.C. 2304(a)(16)). <u>1/</u>
February 1982	One fiscal year 1981 ship was awarded to Electric Boat based on industrial mobilization requirements (10 U.S.C. 2304(a)(16)). <u>1/</u>
April 1982	One fiscal year 1982 ship was awarded to each source based on industrial mobilization requirements (10 U.S.C. 2304(a)(16)).
November 1982	Two fiscal year 1983 ships were awarded to Electric Boat competitively based on price and other factors. However, the Government evaluated the price offered by the two competitors as equal.

1/Each of these contracts has options for up to three additional ships.

11 December 1982

Dear Mr. Bowsher:

This is to confirm my discussion with your audit team on December 10, 1982 regarding your draft report entitled "Analysis of Admiral Rickover's Recommendations to Improve Defense Procurement".

For the most part, your audit team did a good job of looking behind the recommendations and focusing attention on the underlying problems. However, with two exceptions - the recommendations for legislation to establish a statute of limitations for the submission of claims and to authorize departments to award to other than a low bidder in cases of suspected buy-ins - the GAO recommendations are too vague and weak to generate corrective action.

Too often the GAO simply throws the problem back to Congress without a specific recommendation, or advocates another study by the Defense Department. For example:

a. GAO recommends that Congress have the Department of Defense "assess the likelihood of future (shipbuilding) buildup problems and explore ways to maximize the use of existing capacity at the two private yards". The Navy and the Defense Department have made these assessments in the past. The conclusions tend to support whatever program the incumbent Administration is pushing. Rather than have Congress get another DOD report indicating "we have it under control", GAO should make the assessment, arrive at conclusions, and make specific recommendations to the Committee. (See GAO note 1, following this letter.)

b. GAO concludes that the need to reestablish submarine construction capability at a naval shipyard "is moot without Executive-Legislative agreement on long term needs". Here GAO has put off the issue waiting for a consensus on long term shipbuilding needs that may never materialize. Even with such a consensus, the perception of long term needs tends to change with each new Administration and Congress. In my opinion, the need to reestablish submarine construction in a naval shipyard is warranted for business reasons alone - so the Navy can exercise some discretion in the amount of submarine business awarded to private yards. This is not to downplay in any way the importance of the extra capacity and experience the Navy would get by resuming submarine construction in a public yard. Having witnessed the difficulties the Navy has encountered in the past, GAO should state clearly whether it agrees with me that investment in reestablishing submarine construction in a naval shipyard is warranted so the Navy will have a viable alternative to private yards when needed - either for production or business reasons. (See GAO note 2, following this letter.)

c. The GAO endorses Independent Research and Development (IR&D) philosophically; agrees that there is no effective monitoring of IR&D expenditures; and then creates the impression that this area is no longer a problem because of a new review system the Navy is trying out. That is not a sound basis for dismissing an issue of this importance. Further, even if one accepts the theory of IR&D, GAO ignores the substantial problems that arise in situations where contractors or divisions of corporations work entirely for the Defense Department. In these cases, IR&D is equivalent to a Government grant to our largest defense contractors. GAO should address the abuses and make specific recommendations. (SEE GAO note 3, following this letter.)

d. GAO agrees that Defense officials should seek to resolve outstanding business problems with major defense contractors during the budget preparation process so that the Defense Department does not leave itself in the awkward position of getting Congressional approval of programs for which it cannot contract on a reasonable basis. The report includes the Defense Department's detailed explanation of why this is infeasible. Yet, according to press accounts, Secretary of the Navy Lehman recently demonstrated the fallacy of the DOD position by employing exactly this approach with considerable success to negotiate a lower price for the F-18 aircraft prior to including F-18's in the 1984 budget. GAO should so indicate in its report. (See GAO note 4, following this letter.)

f. GAO finesses the work stoppages issue with the following recommendation:

"If the committee concludes that a policy is needed to address work stoppage and related Government financing in situations where the present policy of termination and reprocurement is not feasible, it should request the Defense Secretary to develop one and submit legislation if necessary."

Rather than dump this very real problem back on Congress and the Defense Department, GAO should make specific recommendations. (See GAO note 5, following this letter.)

Vague recommendations, such as those I have mentioned, cannot possibly be of much help to Congress. Congress has a right to expect from the GAO explicit, unequivocal recommendations such as those regarding the need for a statute of limitation on claims and for the Defense Department to be given explicit authority to protect against buy-ins.

In most of the above areas GAO has described the problem reasonably well. The discussion of fraudulent claim statutes, however, misses the point by a wide margin. Yet this is the most important issue of all. At stake is the sanctity of Government contracts. The GAO recommendation to "Resolve pending cases by (1) obtaining prosecutory evidence, or (2) closing cases for lack of evidence" is a "motherhood" recommendation tantamount to useless cheerleading.

The Justice Department has mishandled its investigation of Navy shipbuilding claims. Repeatedly Department of Justice officials, after years of investigating claims which were demonstrably false, overruled their investigators and decided not to prosecute.

Litton was indicted, but then only as a corporation. This rules out incarceration of responsible officials as a deterrent. GAO should find out why, after indicting Litton in 1977, the Justice Department only recently began prosecuting this case aggressively.

GAO should determine why the Justice Department dropped the Lockheed and Electric Boat cases when apparently those who conducted the investigation recommended otherwise.

GAO should find out why the Newport News investigation has languished since 1976, and why the Justice Department repeatedly pulled people off the case. GAO should determine exactly why the Justice Department dismantled the investigative team working on that case shortly after that team reported to the Department that it had grounds for seeking an indictment; what has been done since that time to pursue the investigation; and the extent to which the Department's delays might jeopardize the Government's case due to the statute of limitations.

The Justice Department's record in these cases indicates either gross mismanagement or the need for restructuring false claim statutes. Each time the Justice Department decides not to prosecute in the face of claims that are obviously false, it encourages others to make exorbitant claims against the Government. Unless strong action is taken to make the false claim and fraud statutes effective other defense contractors will be encouraged to adopt this approach whenever they get into financial trouble.

Perhaps the GAO cannot obtain access to Grand Jury information necessary to evaluate the Justice Department's decisions. The GAO, however, can conduct a thorough investigation of the Department of Justice's handling of these cases from a management viewpoint - with particular attention to the adverse effects that delay and frequent rotation of personnel have had.

GAO should also identify what problems exist in applying the false claim and fraud statutes and what changes in law are necessary to make these statutes effective.

A review of the Justice Department's handling of shipbuilding claims should be a good way to measure that Department's performance. The investigations were worthy of the Department's best resources. The sums involved were substantial and the issues far-reaching.

In my opinion, the failure to investigate fully the Justice Department's handling of the fraudulent claims and address the problems in this area squarely is the major deficiency in the GAO report. I urge that the GAO undertake this effort since it is uniquely qualified to do so. (See GAO note 6, following this letter.

Thank you for the opportunity to comment on the draft report. I request that my comments on the draft GAO report be addressed in the final report you send to Congress and appended to it.

Sincerely,



H. G. Rickover

The Honorable Charles Bowsher
Comptroller General of the United States
General Accounting Office
Washington, D.C. 20548

GAO NOTES ON ADMIRAL RICKOVER'S COMMENTSNote 1

GAO disagrees. GAO cannot make the assessment suggested by Admiral Rickover of potential buildup problems over the next decade because the conditions are dynamic and there are major unknowns such as the number of ships that Congress will fund and the amount of other work that may be awarded to the two nuclear shipyards. In other words, we lack the data to make a proper evaluation. The Navy is quite concerned about this potential problem. It has a system to track the buildup and the industrial base expertise to make the evaluation. There is no reason to believe that the Navy cannot make a yearly assessment of the situation and keep appropriate committees advised on the results. Not recognized in Admiral Rickover's comments are some specific options in the GAO report to better utilize and preserve the existing industrial base capacity. These options are to be exercised depending on whether the buildup problems actually materialize and how serious they are. (See ch. 2.)

Note 2

GAO disagrees. Here, Admiral Rickover changed his original basis for restarting submarine construction in a Navy-owned yard by taking the position that business reasons alone would justify such action. We agree with the original recommendation that an action of this magnitude would have to be prompted by both capacity and business needs. While the advantages of having a third nuclear yard when negotiating prices and terms with private industry are undeniable, we do not believe these advantages alone are worth a long-term investment of several hundred million dollars and a sizeable expansion of the Government's workforce.

Note 3

GAO disagrees. GAO does not, as the Admiral implies, walk away from the new Navy monitoring system for industry-initiated R&D or leave the impression that there is no longer a problem. Our report explicitly states that DOD should closely monitor the revised program and, after the program has had an opportunity to operate for a while, DOD should have an independent scientific assessment made of its effectiveness and report the results to the appropriate committees. We also suggest action to overcome the Admiral's concern about charging the Government royalties for inventions derived from this Government supported R&D activity.

Note 4

GAO has not stressed Secretary Lehman's recent action on the F-18 price because DOD's objection to this recommendation goes more to the early budget certification of pre-contract terms and conditions than to the more general issue of using budget leverage.

Note 5

GAO agrees that the recommendation can be strengthened and has modified it accordingly. However, while GAO agrees that a policy in this area is needed, formulation of such a policy should be done by the Congress with DOD, industry, GAO, and others participating.

Note 6

Admiral Rickover's comments on this issue are discussed in the body of the report along with additional information furnished by the Justice Department. (See ch. 4.)



U.S. Department of Justice

APPENDIX V

APPENDIX V

JAN 11 1983

Washington, D.C. 20530

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Anderson:

This letter is in response to your request to the Attorney General for the comments of the Department of Justice (Department) on your draft report entitled "Analysis of Admiral Rickover's Recommendations to Improve Defense Procurement."

In our review of the General Accounting Office (GAO) draft report, we note that only a part of the report covers matters applicable to the Department, i.e., those dealing with the enforcement of fraudulent claims statutes (pp. 58-62). There are two areas that we believe warrant clarification: (1) the rationale for declining the Electric Boat and Lockheed cases (pp. 58-59); and (2) the recommendation that the Criminal Division establish guidelines and standards for future cases (pp. vi, 62).

Declination Reasons

On pages 58-59 of the report, GAO recites Admiral Rickover's explanation of the Lockheed and Electric Boat declinations. In general, the Department declined because thorough investigations revealed insufficient evidence of criminal fraud. These conclusions were reached only after extensive investigations involving a commitment of sizable investigative resources, and were based solely and exclusively upon the merits of the evidence developed by the Navy before referral to the Department, by lengthy grand jury proceedings and by comprehensive investigations of the Federal Bureau of Investigation which were closely coordinated with lawyers in the Department. (See GAO note 1, following this letter)

Standards and Guidelines

The report states that "... DOD said the head of Justice's Criminal Division has expressed a desire to bring together experienced claims personnel from different agencies to (1) improve the claims process and (2) provide additional investigative support to enhance prosecution" (p. 60). The report then states that the "study by the Justice Office of Policy and Management could be helpful if it results in guidelines for future claims submissions and prosecution of fraudulently inflated claims" (p. 62). The report recommends that the "... Committee should request DOD and the Justice Department to ... [e]stablish claims handling procedures and standards for the future that discourage false claims, make evaluation easier, and facilitate prosecution where fraud is suspected" (p. 62; see also p. vi).

Note: The page numbers have been changed to correspond to those in the final report.

-2-

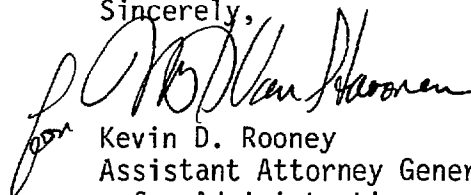
These statements and recommendations reflect some misperception of the Department's role. The Criminal Division is conducting interviews with persons in both Navy and Justice involved in the investigation of the Navy claims matters which the Department declined to prosecute. The Division hopes that, by reviewing and evaluating the experiences in these investigations, it can improve its management of such matters in the future. Because some of the difficulties in constructing criminal cases were the result of the manner in which the Navy handled the claims, the Division's review of its experience with these matters may yield suggestions for changes in the claims process. The Department does not, however, have the ability to unilaterally implement any such changes. Moreover, as the GAO draft report recognizes, the matters declined by the Department related to claims that the Navy processed several years ago. Since that time, the Navy has devoted considerable effort to improving claims administration. It is quite possible that many of the lessons to be learned by studying the cases the Department has declined are reflected in improvements that the Navy has already made. (See GAO note 2, following this letter.)

Finally, Attorney General William French Smith and Secretary of Defense Caspar Weinberger agreed last year upon the establishment of a joint DOD-DOJ fraud procurement unit. This unit is operational, consists of lawyers and investigators from DOD, the military services, and the Department, and will seek to implement many of the Department's concerns and recommendations. The unit will and is currently working actively in this area developing new cases and making improvements in coordinating fraud procurement investigations and prosecutions.

The analysis concluding that the Department should "either (1) obtain the evidence . . . or (2) close these cases . . ." and establish claims handling procedures and standards is naive. The allegations are often general in nature, the claims are complex and detailed, numerous persons are involved in claims preparation and each claim and, consequently, each investigation has a different factual basis and allegation of wrongdoing. None of this lends itself to GAO's common sense but too simple solution. We hope through our self-examination study and the work of the procurement unit recently created, to more efficiently investigate and prosecute complex procurement claims cases. (See GAO Note 3, following this letter.)

We appreciate the opportunity to comment on the draft report. Should you desire any additional information, please feel free to contact me.

Sincerely,



Kevin D. Rooney
Assistant Attorney General
for Administration

GAO NOTES ON DEPARTMENT
OF JUSTICE COMMENTS

Note 1

This information has been added to the discussion of this issue in chapter 4.

Note 2

The Justice Department observes that although its own management review of how well the shipbuilding cases were handled may yield suggestions for changes in the Navy's claims process, Justice cannot implement such changes unilaterally. Further, Justice says the Navy may have already made the necessary improvements. Such an approach seems to sidestep the real issue. GAO believes the Justice Department and DOD should collaborate on these matters fully and work out any changes that would be useful in dealing with future referrals of claims suspected of being fraudulent.

Note 3

GAO acknowledges that the conclusion sounds simplistic. However, while some delay is to be expected, the delays in these cases seem extreme.

Newport News Shipbuilding

A Tenneco Company

4101 Washington Avenue
Newport News, Virginia 23607
(804) 380-2000

January 4, 1983

Mr. Donald J. Horan
Director
Procurement, Logistics, and
Readiness Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Horan:

Our company's comments regarding your draft report entitled "Analysis of Admiral Rickover's Recommendations to Improve Defense Procurement" make up the content of this letter.

Overall I think you have done about the best job possible in summarizing the Rickover statements, the DOD responses and specifying the GAO recommendations on each of the subjects. I have chosen to follow your format in making our comments. Three major areas of defense procurement are addressed:

- 1 - RESOURCE UTILIZATION
- 2 - PROCUREMENT PROCESS
- 3 - CONTRACTUAL CONFLICT RESOLUTION

1 - RESOURCE UTILIZATION

Resource utilization recommendations cover three topics: hasty manpower buildups at shipyards; restarting nuclear ship construction in a Navy-owned yard; and withdrawing financial support for industry-initiated research and development.

Hasty manpower Buildups

- o Rickover believes this to be root cause of large shipbuilding claims.
- o DOD agrees that hasty buildups should be avoided, and plans to contract only with those firms with sufficient manpower at the time of award.
- o GAO recommends that DOD assess the likelihood of future buildup problems and explore ways to maximize the use of existing capacity, including:
 - a. expanding Navy's overhaul capacity
 - b. limiting conventional work at nuclear qualified (private) yards

Mr. Donald J. Horan

- 2 -

January 4, 1983

- c. reserving future nuclear capacity by excluding it from current contract awards
- d. compensating a private yard for setting aside some capacity for future work

Newport News Shipbuilding (NNS) is well aware that the Navy has already gone to an allocation basis. NNS takes exception to the Rickover comments, but agrees that the GAO has reported them fairly. We take exception to GAO's recommendation that conventional work should be limited to nuclear qualified private yards. The margins permitted on conventional work are frequently higher than permitted on nuclear work. The investment required for nuclear work is far higher than that required for conventional work. Therefore, until the margins improve on nuclear work, we intend to bid on whatever conventional work we can handle. We would consider it illegal for the government to tell us that we cannot successfully bid on conventional work. We would also consider it illegal for the government to attempt to reserve future nuclear capacity by excluding us from current contracting awards. We also find it impractical to believe that the Congress or the Administration would allow subsidies to be provided to reserve capacity for future work. There is no need to provide more overhaul capacity at Navy yards. There is already, and will be for many years to come, a large excess of such capacity at private yards and existing Navy yards.

Restarting In-House Nuclear Submarine Construction

- o Rickover says this is required to maintain leverage on private yards.
- o DOD sees no current requirement but wants to maintain the option.
- o GAO believes need is moot without definite long range program.

NNS knows that there is excess capacity for nuclear submarine construction and that it would be an utter waste of taxpayers' funds to restart nuclear submarine construction in a government yard. Past history would show that such construction was highly inefficient taking much longer than private yards.

Withdrawing Support for R & D

- o Rickover says abolish Government support.
- o DOD and GAO disagree but Navy is developing better monitoring.

Mr. Donald J. Horan

- 3 -

January 4, 1983

- o GAO recommends DOD develop policy for royalty-free use of inventions developed under DOD funded R&D programs.

NNS believes the Government's policy on R & D fluctuates widely between various departments of DOD. We see attempts by DOD to monitor R & D more closely. We do not believe the Government has the royalty-free use of patents or inventions, and I believe with DOD that development of a policy would be necessary.

2 - PROCUREMENT PROCESS

Rickover recommends four actions in this category: require DOD budget certification of suitable terms and conditions on sole source contracts; eliminate reliance on special financial incentives; statutory authority for awards to other than low bidders; and, tie future contract awards to improved performance on current contracts.

Budget Certification on Terms and Conditions

- o Rickover wants DOD to certify in budget submittals that suitable terms and conditions have been agreed to by sole source contractors.
- o DOD says this is impractical.
- o GAO says "certification" is too cumbersome, but idea of linking sole source issues to budget decisions has merit. Recommends Congress require DOD to resolve issues prior to budget submit and/or inform Congress of conflicts.

NNS believes that DOD is already diligently trying to resolve terms and conditions prior to final funding of sole source contracts. Certification is not required. To require total resolution prior to budget submittal adds millions of dollars to Government and contractor costs, which would be wasted if funding is not approved.

Eliminate Special Financial Incentives

- o Rickover thinks this practice does not work and recommends more emphasis on good management.
- o DOD states that incentives do work.

Mr. Donald J. Horan

- 4 -

January 4, 1983

- o GAO agrees, but advises extreme care. Recommends Congress get DOD to establish policy guidelines

NNS believes that special financial incentives are in the best interest of the taxpayer and should continue. They are far more motivating to a contractor than the inadequate margins allowed by Admiral Rickover when he was in charge of Naval Nuclear Propulsion.

Statutory Authority for Awards to Other Than Low Bidder

- o Rickover seeks to eliminate "buy-ins" such as E.B. has used on 688s
- o DOD believes current source selection criteria is adequate
- o GAO believes statutory authority would be helpful. Recommends Congress ask DOD to develop appropriate legislation

NNS believes that DOD is already awarding contracts to other than the low bidder in some instances. We know this to be factual in a recent award of two submarines where we were the low bidder and the early deliverer versus our competition. However, the competition received the award for construction of two new submarines. If DOD believes they do not need statutory authority to do so we see no need then to implement it.

Future Contract Awards Tied to Improved Performance

- o Rickover thinks future contract awards linked to improvements in performance on current contracts would be good leverage
- o DOD says this is already done
- o GAO recommends Congress ask DOD for report on this matter

NNS agrees with DOD.

3 - CONTRACTUAL CONFLICT RESOLUTION

Rickover recommends three actions in this area to effect improvements: one year limitation on filing of documented claims; stop payments corporate-wide if work stoppage occurs on single contract; and, enforce fraudulent claims statute.

One Year Claim Submittal Limitation

- o Rickover believes long period before claim submittal used to recover profits on total contract
- o DOD agrees with one year limit

Mr. Donald J. Horan

- 5 -

January 4, 1983

- o GAO thinks some time limit is required. Recommends Congress obtain additional views

NNS believes the one year limit is totally inadequate. There are numerous instances in which the contractor is unable to determine the extent of his costs and damages as a result of legitimate contract changes. A notification of changes clause is already in use on some contracts. We oppose the introduction of time limits, particularly since the impact upon other contracts of major changes on a given contract may not be determinable for many years. Inadequate government furnished equipment is frequently the cause of legitimate requests for adjustment and the contractor may not know the inadequacies of such equipment for years after it has been delivered.

Work Stoppage Causes Stop Payment

- o Rickover would put burden on total corporation for work stoppage on a single contract
- o DOD says probably illegal and impractical
- o GAO believes this is unworkable. Recommends Congress consider policy development for special cases (i.e. sole source or large ship construction contracts.)

NNS agrees with GAO that Rickover's suggestion is unworkable. We further do not believe there is any practical way that Congress could develop a policy for such cases.

Enforce Fraudulent Claims Statutes

- o Rickover is frustrated that his fraud charges have not been substantiated
- o DOD agrees with enforcement, but acknowledges that prosecution is difficult
- o GAO thinks claims certification will help alleviate future problems. Recommends Congress ask DOD and Justice Department to resolve pending cases, and establish claims handling procedures and standards which discourage false claims, make evaluation easier, and facilitate prosecution.

: Donald J. Horan

- 6 -

January 4, 1983

NNS is one of the companies where fraud charges have been instigated by Admiral Rickover and are still unsettled within the Government 4-1/2 years later. Millions of dollars have been spent by our company in defending against such charges and the government has probably spent more millions based upon Admiral Rickover's allegations. We agree with GAO's recommendations that pending charges should be settled.

Attached are some suggestions for minor changes in your draft. Thank you for your courtesy in allowing us to review the draft.



Edward J. Campbell
President and
Chief Executive Officer

nclosure

opy to Mr. Bert Hall

SPECIFIC RECOMMENDATIONS FOR TEXT CHANGES TO THE GAO REPORT

- page 6 GAO has taken license with the wording of Rickover's testimony. The phrase "many believe" should be changed to "he believes".
- "First, he wanted the Navy to avoid the recurrence of hasty manpower buildups in private shipyards which many believe were the root cause of large claims in the 1970's."
- page 7 Citing the opinions of "experts" without establishing their credentials is irresponsible. The reference to rapid manpower buildups and declines causing large claims should be deleted.
- "Experts inside and outside DOD generally agree that rapid manpower buildups and declines have been an underlying cause of shipbuilding inefficiencies, defects in workmanship, schedule delays, and ultimately, large claims against the Government."
- page 7 The stated opinion of a program manager implies that no training occurred. Unless factual evidence is presented, the example should be deleted.
- "An example cited by a Navy program manager was that journeyman welders became supervisors overnight and people with no experience became welders."
- page 30 A GAO statement implies that the decision to allow both a special incentive and schedular adjustment in the CVN71 contract was improper. The statement should be deleted.
- "In spite of Admiral Rickover's warning, the contract was modified in December 1981 to include provisions for an additional incentive payment for early delivery and possible adjustments in the December 1986 target delivery date."
- page 32 With regard to special incentives, the first statement of risks to the Government is not required. The statement should be deleted.
- "In these situations there are risks of -- the contractor getting paid the additional incentive despite the failure to achieve the original target because of Government-caused delays or other problems."

Note: The page numbers have been changed to correspond to those in the final report.



THE UNDER SECRETARY OF DEFENSE

WASHINGTON D.C. 20301

RESEARCH AND
ENGINEERING

13 JAN 1983

Mr. Donald J. Horan
Director, Procurement, Logistics and
Readiness Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Horan:

This is in reply to your letter of 8 December 1982 to the Secretary of Defense regarding your draft report entitled "Analysis of Admiral Rickover's Recommendations to Improve Defense Procurement," dated November 1982, OSD Case No. 6151, GAO Code No. 942173.

The draft report represents a well-balanced treatment of a series of recommendations that are quite controversial, even among procurement experts, and DoD agrees in most cases with GAO's assessment of the matters that it intends to bring to the attention of Congress. However, there are some important points of disagreement, which are highlighted below and elaborated on in the attachment. DoD is generally concerned that several of the GAO's suggestions involve significant policy changes that may be most appropriately applied Government-wide. Yet those changes are predicated on special circumstances related to a particular segment of the Defense acquisition spectrum. DoD's analysis of the problems associated with those circumstances has already produced lessons learned that have been applied as appropriate within the DoD. DoD thus believes that it has a head start on implementing the suggestions contained in the draft report on which there is agreement.

Although the GAO staff disagreed with Admiral Rickover's recommendation that the Secretary of Defense should certify contractor agreement to suitable terms and conditions in support of Defense budget requests (a GAO judgment with which DoD concurs), there remains a clear GAO intent that contractor-DoD discussions should be used informally to determine terms and conditions. DoD believes that the unavoidable time delay between budget formation and contract negotiation, which may be as much as two years in shipbuilding, precludes this approach to discussions. Contract terms and conditions should not be emphasized so early in the procurement cycle that they detract from the broader view of defense requirements.

DoD is certainly in favor of treating financial incentives and bonuses in the most mutually beneficial manner for Government and industry. But it is premature to develop a policy to limit special incentives before it is understood whether the conditions under which such incentives might apply are susceptible to specification. No steps should be taken before it has been ascertained that DoD contract negotiators will not be unduly constrained.

The draft report recommends legislation that would give a government agency head discretionary authority to award a contract to other than the lowest bidder when an undesirable buy-in attempt is suspected. Even though the draft report suggests that qualifying contracts be limited to a narrow range of conditions that in GAO's judgment would encourage buy-in attempts, by overvaluing cost competition and undervaluing cost exposure to the Government, in the DoD view it is far from clear that qualifying and non-qualifying contracts can be unambiguously separated. Thus it is doubtful that additional legislation would add measures having practical management value.

Finally, DoD certainly agrees that past performance should be taken into account in the evaluation criteria appropriate for contract awards. But the corollary idea -- that the prospect of contract awards should be used as a lever to "improve" performance on current contracts -- is undesirable because it is very susceptible to uneven application. Thus it would have a high potential for actually increasing complications and delays.

The opportunity to comment on the draft report is appreciated, as is the courtesy and consideration that has been shown by the GAO staff.

Sincerely,



James P. Wade, Jr.
Principal Deputy Under Secretary of
Defense for Research & Engineering

Attachment

GAO Note: We obtained DOD's official comments on our draft report orally and in writing in a January 4, 1983, meeting. These comments are reflected in the report body. After the report was finished we received this approved written version of DOD's comments. Although these written comments were received too late to be addressed in the report body, we are including them in the appendix at the request of DOD officials. The positions DOD has taken remain substantially the same as before. However, in a few cases they have been expressed in different words. This is particularly noticeable in DOD's attached discussion of Buy-Ins (item 6).

Comments on Matters Suggested by GAO for Congressional Consideration

1. Manpower Buildup Problems (Digest pages iii-iv; Report pages 19-20):

DoD agrees that it should be prepared to include assessments of the likelihood of future buildup problems and explore ways to best maximize the use of existing capacity at the two private yards in connection with any proposals for increased construction of nuclear ships. Since performing such assessments would not be a new effort, DoD recommends that the Draft Report be modified on pages iii and 19 to read ". . . to include an assessment of the likelihood of future buildup problems"

Assessments will not per se remove buildup problems. This would be possible in the long run only if executive - legislative agreement on a stable shipbuilding program could be reached.

2. In-House Nuclear Submarine Construction Matters (Digest iv; Report 29):

DoD agrees that any need to open a third nuclear construction yard should be based on positive indications resulting from the assessment of future buildup problems referred to in item 1 above.

3. Independent Research and Development Matters (Digest v-vi; Report 43):

DoD agrees that it should closely monitor the revised program for monitoring IR&D and be prepared to develop a policy on government rights to free use of inventions developed with government support. However, independent assessment of program effectiveness should be accomplished by a qualified technical management body, rather than by a "scientific body" as stated on pages vi and 43.

DoD recommends that the last three lines on page v be changed to read "Admiral Rickover is correct about past weaknesses in monitoring of these contractor activities, and the Navy has designed a new program to correct them."

The reference to "extra" costs for brochure preparation at the bottom of page 36 is ambiguous. If the manager meant that most of the costs would still be incurred in internal planning documentation and external publicity for the company's developments, it would be preferable to so state.

On page 39, fourth paragraph, DoD recommends replacing "Revising the DOD form" with "Working with OSD to revise the DOD form"

Between pages 33 and 43, the report should refer uniformly to the term "IR&D" for Independent Research and Development, since there are other categories of company R&D that are beyond the scope of the consideration here.

4. Matters of Budget Certification on Contract Terms and Conditions
(Digest vi-vii; Report 52-53):

DoD agrees that it would be impractical to require the Secretary of Defense to certify that suitable terms and conditions for single-source contracts had been established prior to submission of the budget. But even though the draft report suggests a less formal approach than certification, the report nevertheless clearly intends that the purpose of pre-budget discussions should be the resolution of contract terms and conditions. DoD believes that uncertainties associated with the time lag between budget submission and contract negotiation -- often as much as two years in shipbuilding -- precludes any possibility of advance agreement. It would thus be undesirable for Defense officials to attempt to resolve specific terms and conditions so far in advance of a contract and prior to actual appropriations. It follows that DoD officials ought not to be required to address unresolved issues of advance terms and conditions in prepared testimony associated with the budget. DoD also disagrees with the suggestion that Congress should become involved in "assistance" with specific contract terms and conditions.

5. Matters of Financial Incentives and Bonuses (Digest vii-viii; Report 62):

DoD believes it is premature to "develop a policy limiting the use of special incentive provisions by specifying the conditions under which they may be appropriate." (Emphasis added.) DoD does not object to giving careful consideration to the use of incentives, nor to trying to establish whether there exist specifiable appropriate conditions. But until the existence of such conditions has been established, any requirement to develop a policy based on them is liable to lead to unnecessary and unworkable constraints on the negotiating process.

6. Matters of Buy-Ins (Digest viii-ix; Report 76):

DoD agrees that it is desirable to encourage more cost realism in contractor proposals, but not that it would be appropriate at this time to pursue that goal through an amendment to the Armed Services Procurement Act that would authorize the award of contracts to other than the low bidder, when in the judgment of the department head an undesirable buy-in is suspected.

It is recognized that GAO intends the new anti buy-in legislation to apply only to special cases involving a very narrow base of competition for products of mature design, but which require extended construction periods. In such cases cost is likely to dominate the evaluation criteria, and there is high potential for financial recovery from a buy-in from the numerous change orders that are likely during the contract period. But in DoD's view there are conceptual difficulties involving the demarcation between programs that would qualify for discretionary authority and those that wouldn't, as well as between those that should and those that shouldn't. Until it is established that unambiguous distinctions can be made and serious difficulties avoided, DoD cannot agree that the matter is beyond the stage where more careful study of the desirability of legislation is warranted. Additionally, the problem of buy-ins is broader than shipbuilding or even defense, and legislation may or may not be an appropriate general remedy.

7. Matters of Past Contractor Performance (Digest ix; Report 85):

DoD agrees that it can report on changes that have occurred as a result of DoD efforts to increase the use of past performance as a contract award criterion.

DoD does not agree that contract awards should be used as a direct lever over current contract performance. The practice could easily lead to situations in which contractors make changes outside the scopes of current contract efforts, while they are engaged in competition for new awards, with the subsequent risk to the Government that claims for the changes will be submitted subsequent to the new awards. Another result would be a higher potential for litigation on current contracts and the results of awards, especially if a contractor concluded that he had unjustly been denied an award after having cooperated fully in adjusting his current performance.

DoD thus also disagrees that the Executive should report to the Legislature on changes "needed" in the contract award process for the purpose of making awards into potential levers over performance. DoD recommends that the suggestion to that effect in the last sentence on page 85 of the draft report be deleted, as well as the reference to business leverage on page x. 1/

8. Matters of Time Limits on Claims (Digest x; Report 96):

DoD agrees to the desirability of legislation that would provide a statute of limitations on the submission of claims, as well as possible amendments providing prompt notification of alleged changes and periodic releases from claims. However, DoD does not yet agree that a one-year limitation is appropriate and is unprepared to make a recommendation prior to additional analysis.

9. Matters of Work Stoppages (Digest xi, Report 106):

DoD does not agree that a new policy is needed to prohibit work stoppages. The Navy considers that its contracts are enforceable and that the Disputes Clause in ship construction contracts as well as certain others requires the contractor to continue performance pending resolution of a dispute, even for an alleged breach. Subject to further analysis, it would be preferable not to adopt policies that might appear to weaken the authority of existing policies.

10. Matters of Fraudulent Claims (Digest xii; Report 116):

DoD agrees that pending cases should be resolved and that improved claims handling procedures and standards should be established.

1/GAO note: In preparing the final report we modified this part of the "Matters for congressional consideration."